Lease Accounting - New Changes in US, International and Government Accounting Standards

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ABSTRACT

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) implemented a joint project to take a fresh look at the current leasing guidance to increase transparency on the balance sheet and to disclose key information about leasing arrangements. Although the joint projects diverged with different standards being issued, the guidance from the boards have many similarities. This research reviews the new standards and updates issued by FASB, IASB as well as the Government Accounting Standards Board (GASB). It summarizes and contrasts the recent work done by all three accounting standards boards, recognizing the implications for future financial statements and analysis.

INTRODUCTION

A lease is a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment for a period of time in exchange for consideration. Leases have become more and more popular because some companies would rather use an asset and not have it on their books than reporting the asset on their balance sheets and exposing all the associated liabilities and risks. According to Glover (2016) over $3.3 trillion of existing assets were acquired by leases and the vast majority of them are not included on the balance sheet (p. 1).

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) implemented a joint project to take a fresh look at the current leasing guidance to increase transparency on the balance sheet and to disclose key information about leasing arrangements. Although the joint projects diverged with different standards being issued, the guidance from the boards have many similarities. This research reviews the new standards and updates issued by FASB, IASB as well as the Government Accounting Standards Board (GASB). It will summarize and contrast the recent work done by all three accounting standards boards, recognizing the implications for future financial statements and analysis.

REVIEW OF THE STANDARDS

FASB

The previous FASB standard about leases treated finance leases and operating leases differently when it came to reporting the lease assets and lease liabilities on the balance sheets. A finance lease was defined as one where the lessor is the legal owner of the asset, but the lessee has operating control and shares a lot of the risks associated with the valuation of the assets. Finance leases are said to be treated like loans, which creates liabilities to the loaner companies. On the other hand, operating leases were
defined as a lease where the lessor takes the risk and the lessee returns the asset when the company is done with it, or at an agreed upon point of time. In the previous standard, only if a company had a finance lease would it have to report the asset and related liability on the balance sheet. This caused unfair treatment. Specifically, there were problems with faithful representation that arise when dealing with operating leases.

To fix the problem regarding reporting of assets and liabilities from operating leases, FASB issued Topic 842, an Accounting Standards Update (ASU), in February of 2016. There have been a few small amendments since then. In the ASU, change was made in order to “increase the transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements” (FASB Topic 842, 2016, p.1). There was still a distinction between finance leases and operating leases, although the recognition on the balance sheet was changed to be the same. The key changes include among other things: the definition of what constitutes a lease; all leases longer than 12 months will be recognized on the balance sheet; separating and allocating consideration to lease and non-lease components; accounting for sale-leaseback transactions to better interplay with the revenue recognition requirements under ASC 606; and enhancing financial statement disclosure requirements. Topic 842 updates will take effect for public business entities for calendar periods beginning after December 15, 2018. FASB (2016) states,

“Under the new guidance, a lessee will be required to recognize assets and liabilities for leases with lease terms of more than 12 months. Consistent with current Generally Accepted Accounting Principles (GAAP), the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. However, unlike current GAAP—which requires only capital leases to be recognized on the balance sheet—the new ASU will require both types of leases to be recognized on the balance sheet.

The ASU also will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, providing additional information about the amounts recorded in the financial statements.” (p. 8)

Previously there were differences in accounting for finance leases and operating leases, it is also the case now after the update. The main difference is that assets and liabilities arising from operating leases is recognized in the balance sheet. They also are initially measured at the present value of the lease payments. All cash payments within operating activities are placed in the statement of cash flows. For finance leases, a right-of-use asset and a lease liability, also measured at present value, are placed in the statement of financial position. Interest, however, is recognized separately from the amortization in the statement of comprehensive income. Payments towards the principal is part of financing activities whereas interest payments and variable lease payments within operating activities is in the statement of cash flows. It is important to note that if the lease has a term less than 12 months, the lessee is able to elect not to recognize lease assets and lease liabilities. If this election occurs, then the lessee has to recognize lease expenses related to this type of lease using the straight-line method.

Topic 842 requires that companies must separate the lease components from the non-lease components. A non-lease component can be, for example, a maintenance contract. This was a requirement under the prior FASB standard, but Topic 842 provides more guidance on how to identify and separate the components. Under Topic 842, only the lease components must be accounted for. Disclosures on financial statements are still required by the lessor and the lessee to provide information to
stakeholders about, among other things, cash flows due to lease transactions. Also, guidance in transition when applying the new lease reporting requirements is presented in Topic 842. The lessor and lessee will use a modified retrospective approach.

The perspectives of the Big Four accounting firms are important to understanding the impact of Topic 842 on financial statements as well the implementation process. According to Deloitte (2018), the new leasing guidance brings most leases onto the balance sheet; aligns certain of the underlying principles of the lessor model with those in ASC 606; and addresses the concerns related to the nearly 40-year old leasing model from the previous guidance. With this being said, the new accounting for operating leases will substantially impact the balance sheet, particularly for companies in industries with numerous operating leases. The implementation of Topic 842 will increase the recognition of assets on the balance sheets which will add value. However, the recognition of the corresponding lease liabilities will add risk. FASB believes Topic 842 will serve stakeholders by increasing, “transparency and comparability among organizations by recognizing lease assets on the balance sheet and disclosing key information about leasing transactions. (Deloitte, 2018, p. 1)

PWC (2017) published a survey of accounting practitioners who are directly dealing with implementing lease accounting changes to provide their opinions on the implementation process and share their views of the new update. Most practitioners agreed that although it will take much work to update the balance sheets and financial statement disclosures of companies, Topic 842 implementation will be beneficial in the long run. Companies already have begun to develop new processes in order to make their financial reporting changes less costly. Accountants are encouraging companies to understand the new ASU, gather information, evaluate the impact, select a transition approach, and implement and monitor the changes as they occur.

IASB
When releasing IFRS 16, the new leasing standard, Hans Hoogervorst, chairman of IASB, said, “These new accounting requirements bring lease accounting into the 21st century, ending the guesswork involved when calculating a company’s often substantial lease obligations. The new standard will provide much needed transparency on companies’ lease assets and liabilities, meaning that off balance sheet lease financing is no longer lurking in the shadows. It will also improve comparability between companies that lease and those that borrow to buy.” (IASB, 2016, p. 1). The use of leases is something that has had an impact on the faithful representation of a company’s financial statements. The total amount of assets and liabilities have been questioned, as some were not fully stated on the balance sheets. With this new standard, much of the guesswork relating to balance sheets will be mitigated. IFRS 16 will become effective for companies that report under IFRS on or after, January 1, 2019.

IFRS 16 is replacing IAS 17, when it comes to how companies account for their leases and applies to both lessees and lessors. Under IAS 17, leases were required to be classified as either finance or operating leases. Finance leases transferred all of the significant risks and rewards associated with them. All other leases are considered operating leases. The classification of the lease needed to be disclosed at the beginning of the lease, for both of the lessee and lessor, in determining how the lease would be accounted for. For lessees, finance leases were recorded at the beginning of the lease term, as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments, discounted at the interest rate that was explicit in the lease. Then, the finance lease payments were apportioned between the outstanding liability and the finance charge. For operating leases, the lease payments were recognized as an expense on the income statement over a straight-line basis, unless
otherwise specified. For lessors, the finance lease was recorded in the balance sheet as a receivable at the beginning of the term of the lease and the income was recognized on a pattern of the periodic rate of return. For operating leases, the nature of the asset determined where it was recorded on the balance sheet, in the intangible assets section or under equipment, and the income was recognized over the lease term. Disclosures were required for both finance and operating leases which helped investors understand some aspects of the nature of the lease. However, although disclosures were there, many investors still were confused by the discrepancies in the financial statements.

IFRS 16 had two objectives when it was released: the first was to faithfully represent lease transactions, and the second was to provide a basis for external users to assess the amount, timing and uncertainty of cash flows arising from leases. This required lessees to recognize the assets and liabilities arising from the lease. IFRS 16 tries to simplify the process and presents a single lessee accounting model, that requires the lessee to recognize the right of use asset, representing its right to use the asset and a lease liability on the balance sheet. In effect, all leases are treated as financial leases. The lessee must recognize depreciation on the asset and interest on the lease liability. In the statement of cash flows, the lessee would separate the amount of cash paid to principal and to interest. When it comes to the lessor, IFRS 16 carries forward the accounting requirements from IAS 17. That is, lessor accounting did not change. A lessor continues to classify its lease as operating or financing, and accounts for these leases differently.

Although there are similarities, there are also differences. Klein states, “One of the clearest differences between the two is the classification criteria for leases. FASB chose to maintain the dual model approach for lease classification. Most leases will be treated as finance leases. However, operating leases under twelve months will be treated as they were before Topic 842 and be expensed as they always have been. IASB now requires a single model” (Klein, 2018, p. 1) Since the IASB eliminated the operating lease classification, all leases will be expensed as finance leases as in IAS 17. Leases will be expensed using both depreciation and an interest expense. Because of the classification differences between Topic 842 and IFRS 16, some lease payments will be reported differently on the income statement and the statement of cash flows. Also, the transition approaches are different. IFRS allows companies to choose between the full retrospective approach and the modified retrospective approach while FASB requires a modified retrospective approach.

**GASB**

GASB Statement 87 was issued in June 2017 and will be effective for government reporting after December 15, 2019. According to the National Federation of Municipal Analysts (2018),

“The pre-GASB 87 approach to lease accounting required a somewhat subjective determination of whether a lease was classified as a “capital lease” or an “operating lease.” That lease classification was based on any one of four tests that assessed which party, the lessee or the lessor, bore the benefits and risks of ownership. Historically, that lease classification was somewhat subjective and certainly varied from government to government. In addition, there was not much note disclosure required regarding the terms of the lease and leased assets, or the basis for the determination if the lease was an “operating lease” or a “capital lease.” P.1

When issuing GASB Statement 87, the objective was to better meet the informational needs of the financial statement users by improving the accounting and financial reporting for leases by governments. Like IFRS 16, GASB Statement 87 requires a single model for lease accounting, with the fundamental principle that leases are financings of the right to use an asset. GASB no longer contemplates the
distinction between operating and capital leases, and now requires that there is financial statement
recognition of assets and liabilities for all leases, with limited exceptions.

GASB (2017) defines a lease as “A contract that conveys control of the right to use another entity’s
nonfinancial asset as specified in the contract for a period of time in an exchange or exchange like
transaction.” (p.1). Lease terms are defined by GASB as the period during which the lessee has a
noncancelable right to use the underlying asset, plus some exception extension periods. The lease
liability is measured as the present value of future lease payments under the expected term of the lease.
The lease asset is measured by the lease liability plus any payments made to the lessor at before the
commencement of the lease. The lease liability is reduced over time as lease payments are made. A
portion of those lease payments are comprised of current interest expense and the remainder is a reduction
of the lease liability.

GASB distinguishes between short term and long-term leases based on their contract periods. Short
term leases have a maximum contract of 12 months, and lessees and lessors should recognize these lease
payments as outflows or inflows of the resources. The difference between short term and long term leased
assets are that long term leases require recognition of the lease liability and assets at the commencement
of the lease term. For all leases, GASB requires that the notes to the financial statements should include
descriptions of the leasing arrangements, the schedule of the future lease payments to be made and the
amount of lease assets recognized. GASB requires in Statement 87 that the lessee recognizes a lease
liability and an intangible right to use lease asset. The lessor must recognize a lease receivable and a
deferred inflow of resources, enhancing the consistency and relevance of the information about the
leasing activities.

Also, in its Statement, GASB (2017) addressed the costs and benefits. The Board assessed the
expected benefits and perceived costs. GASB believes that the costs are justified when compared to the
overall expected public benefit. The Board is aware that the costs of implementing the standard may be
significant. To reduce the cost of the implementation, the statement provides an exception for short term
leases and for contracts that transfer ownership, as well as provisions on reassessing the lease term and
requiring governments to report multiple-component contracts of a single lease unit when determining
estimates. However, the board believes the benefits of transparency and the additional guidance relating
to lease accounting will outweigh the costs.

CONCLUSION AND FUTURE IMPLICATIONS

Many corporations and municipalities lease big-ticket items. Under the past accounting rules,
sometimes all or sometimes nothing has been recognized on the balance sheet even though the lease
transactions have been economically similar. New standards were needed for more faithful
representations of leased assets for companies, both headquartered in the US and internationally, and for
government.

Three accounting standards boards, FASB, IASB and GASB, recently developed new leasing
standards that already have been or will soon be implemented. The goal of all of these boards is to
increase transparency of financial statements. All of the standards will essentially minimize off-balance
sheet financing by recognizing leases and corresponding assets on the balance sheet at the inception of the
lease. Income statements and cash flow presentations will be impacted by replacing rent expense with
depreciation and interest expense.
The new standards will not only affect statement requirements, they will affect many of the commonly used financial ratios such as those that measure debt and debt coverage as well as profitability ratios, such as, return on equity and earnings per share. The newly calculated financial ratios may trigger breaches in loan covenants as well as affect future credit ratings. In addition, corporate management may be faced with issues relating to tax treatment of leasing transactions. New standards were needed for more transparent and faithful representation of leased assets. However, both internal and external stakeholders will need to understand the implications of the new leasing standards to aid in future decision making.

WORKS CITED


