

Accounting Latest Developments: Part 2

Continuing the survey of current accounting developments, this section picks up the conversation and digs deeper into the issues introduced earlier. For professionals who need thorough, up-to-date awareness of what's shifting in the accounting landscape, this coverage helps ensure nothing significant gets overlooked. It's especially useful if your work puts you at the intersection of financial reporting and compliance, where staying fully informed isn't optional — it's essential to serving clients and stakeholders well.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Review how a lease asset is accounted for by a lessee under the lease standard.
- Identify the way in which a lessee accounts for initial direct costs under the lease standard.
- Recognize how to account for CAM charges under the lease standard.
- Recognize a permitted rate that can be used to compute a lease liability under the lease standard.
- Review the requirement of ASU 2023-01's practical expedient as it applies to short-term leases.
- Identify ASU 2023-01's rule for amortizing leasehold improvements with a lease between entities under common control.
- Review the IRS rule for determining whether a lease is capitalized for tax purposes.
- Identify a challenge that may exist if a company uses the AICPA's FRF for SMEs.

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Section 1.3

Chapter Objective

After completing this section, you should be able to:

- Review how a lease asset is accounted for by a lessee under the lease standard.
- Identify the way in which a lessee accounts for initial direct costs under the lease standard.
- Recognize how to account for CAM charges under the lease standard.
- Recognize a permitted rate that can be used to compute a lease liability under the lease standard.
- Review the requirement of ASU 2023-01's practical expedient as it applies to *short-term leases*.
- Identify ASU 2023-01's rule for amortizing leasehold improvements with a lease between entities under *common control*.
- Review the IRS rule for determining whether a lease is capitalized for tax purposes.
- Identify a challenge that may exist if a company uses the AICPA's FRF for SMEs.

M. POST-IMPLEMENTATION ISSUES– NEW LEASE STANDARD– ASU 2016-02 AND ASU 2023-01

Overview

In 2026, companies must still deal with the post-implementation issues related to the lease standard.

Year 2022 was a big year for nonpublic entities as they were required to implement the lease standard found in ASU 2016-02, Leases (Topic 842). The standard was effective for December 31, 2022 year-end for nonpublic entities, and effective in 2019 for SEC companies and most other entities.

ASU 2016-02 represents a culmination of a decade's work to dramatically transform how companies account for leases.

The amendments made by the ASU require that most leases be capitalized resulting in billions of dollars of assets and liabilities being recorded on company balance sheets.

Further, all entities must continue to apply the standard for all new leases created in 2025, 2026, and beyond. Therefore, accountants must know the lease rules on an ongoing basis.

Basic concepts of the final lease statement

The core principle of the lease standard is that an entity should use the right-of-use model to account for leases which requires the entity to recognize assets and liabilities arising from a lease.

Thus, most existing leases are brought onto the balance sheet under the new standard.

In accordance with the right-of-use model:

1. A lessee recognizes assets and liabilities for any leases that have a maximum possible lease term of more than 12 months.
 - a) Lessees that have leases with terms of 12 months or less, have the option of keeping their leases off-balance sheet or recording lease assets and liabilities under the new ASU.

Lessee rules

1. At the commencement date, a lessee measures both of the following:
 - a) A lease liability (liability to make lease payments)
 - b) A right-of-use asset (right to use the leased asset for the lease term)
2. Lease liability: The lease liability is recorded at the present value of the lease payments over the lease term, discounted using the rate the lessor charges (the lessor's imputed rate) the lessee based on information available at the commencement date.
 - a) If the lessor's imputed rate cannot be readily determined, the lessee uses its incremental borrowing rate.
 - b) Nonpublic entities will be permitted to use a risk-free discount rate, determined using a period comparable to that of the lease term, as an accounting policy election for all leases. The risk-free discount rate is defined as a U.S. Treasury instrument rate for the same term as the lease.
3. Right-of-use asset:
 - a) At the commencement date, the cost of the right-of-use asset consists of all of the following:
 - The amount of the initial measurement of the lease liability
 - Any lease payments made to the lessor at or before the commencement date, less any lease incentives received from the lessor, and
 - Any initial direct costs incurred by the lessee that meet the definition of incremental costs as follows: "Incremental costs of a lease that would not have been incurred if the *lease had not been obtained (executed)*."
 - b) Initial direct costs that meet the definition of incremental costs are included as part of the cost of the right-of-use asset capitalized and may include:
 - Commissions paid lessee to secure the lease, and
 - Payments made by a lessee to an existing tenant to incentivize that tenant to terminate its lease.
 - c) The following items are examples of costs that are not initial direct costs:
 - General overheads, including for example, depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time, and

- Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities.
- Costs related to activities that occur before the lease is obtained, such as costs of obtaining tax or legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee's financial condition.

4. Lease payments- lessee:

a) At the lease commencement date, lease payments included in the computation of the lease liability consists of the following payments related to the use of the underlying asset during the lease term that are not yet paid:

- Fixed payments, (including in-substance fixed payments), less any lease incentives receivable from the lessor
- Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date
- Variable lease payments that are in-substance fixed payments

Note: The final statement changed the exposure draft so that variable lease payments are included in the initial measurement of lease assets and liabilities only if such payments depend on an index or a rate.

- Amounts expected to be payable by the lessee under residual value guarantees
- The exercise price of a purchase option if the lessee is "reasonably certain" that the lessee will exercise the purchase option
- Payments for penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease
- Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction, and
- For a lessee only, amounts *probable* of being owed by the lessee under residual value guarantees.

How are CAM charges and reimbursements accounted for in lease contracts?

CAM charges CAM charges are not part of the lease because they do not involve transfer of the right to use the leased asset.

Instead, CAM charges transfer a non-lease service to the lessee in the form of maintenance services and are treated as a separate non-lease component in the contract. The transferred service involves providing maintenance services and not use of the leased asset. Consequently, CAM charges may be included in the lease contract but have nothing to do with the lease obligation calculation and are not included in lease expense or cost. Instead, CAM charges are accounted for as follows:

- If CAM charges are included in the fixed lease payments under the contract, the total fixed lease payments must be separated into two components:
 - Fixed lease component, and
 - CAM non-lease component.
 - The fixed lease component is part of lease payments used in the present value computation of the lease obligation.
 - The CAM non-lease component is excluded from lease payments, not capitalized, and are recorded to maintenance expense as incurred.
5. Lease term: An entity determines the lease term as the noncancellable period of the lease, together with all of the following:
- a) Periods covered by an option to extend the lease if the lessee is “reasonably certain” to exercise that option, and
 - b) Periods covered by an option to terminate the lease if the lessee is “reasonably certain” not to exercise that option.
 - c) Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.
 - d) Reassessment of lease term: A lessee shall reassess the lease term only if at the point in time any of the following occurs:
 - There is a significant event or a significant change in circumstances that is within the control of the lessee that directly affects whether the lessee is “reasonably certain” to exercise or not to exercise an option to extend or terminate the lease or to purchase the underlying asset.
 - There is an event that is written into the contract that obliges the lessee to exercise (or not to exercise) an option to extend or terminate the lease.
 - The lessee elects to exercise an option even though the entity had previously determined that the lessee was not reasonably certain to do so.
 - The lessee elects not to exercise an option even though the entity had previously determined that the lessee was reasonably certain to do so.

Lease liability

1. The lease liability shall be measured at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement.
2. The discount rate used to determine the present value of the lease payments for a lessee is basis of information available at the commencement date.

a) A lessee should use the rate implicit in the lease whenever that rate is readily determinable.

- The rate implicit in the lease is the rate that, when used to present value the lease payments, results in a present value equal to the fair value of the leased asset.
- In layman's terms, the rate implicit in the lease is the internal rate of return (IRR) that equates the present value of the lease payments to the fair value of the leased asset, at the commencement date:

Lease payments x PV factor at ____% discount rate = Fair value of leased asset

b) If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate.

- *Incremental borrowing rate* is the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment.

c) Practical expedient: risk-free rate of return- nonpublic entities:

- A lessee that is not a public business entity (e.g., nonpublic entity) is permitted to make an accounting policy election to use a risk-free discount rate (e.g., U.S. Treasury Rate) for the computation of its lease obligations, determined by using a period comparable with that of the lease term.
- An entity that chooses to use the risk-free rate of return may use the risk-free rate by class of asset (rather than to all leases entity-wide)₁.
- If the use of risk-free rate election is made, an entity shall disclose its election and the class or classes of underlying assets to which the election has been applied.

Note: When the rate implicit in the lease is readily determinable for any individual lease, the lessee must use that rate (rather than a risk-free rate or an incremental borrowing rate), regardless of whether it has made the risk- free rate election₂.

Classification of leases for lessees

1. ASU 2016-02 establishes two types of leases for lessees:

- a) Finance lease (Type A lease)
- b) Operating lease (Type B lease)

Finance lease (Type A lease) - lessee

Definition of a finance lease

A lessee shall classify a lease as a finance lease when the lease meets any of the following five criteria at lease commencement:

- **Criterion 1:** The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- **Criterion 2:** The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- **Criterion 3:** The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

Note: A lease term that is 75% or more of the remaining economic life of the underlying asset is considered a major part of the remaining economic life of that asset.

- **Criterion 4:** The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all (90% or more) of the fair value of the underlying asset.
- **Criterion 5:** The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Measurement of a finance lease

1. A finance lease

- a) Applies to most leases of assets other than property (for example, equipment, aircraft, cars, trucks).
- b) Recognizes a right-of-use asset and a lease liability, initially measured at the present value of lease payments.
- c) Recognizes the unwinding of the discount on the lease liability as interest separately from the amortization of the right-of-use asset.
- d) Records total expense on an accelerated basis and shown in two expense components on the income statement:
 - Interest expense (accelerated), and
 - Amortization expense (straight-line).

Operating lease (Type B lease) - lessee

Definition of an operating lease

For a lessee, ASU 2016-02 defines an operating lease (Type B lease) as any lease other than a finance lease.

Thus, an operating lease is any lease that does not meet any of the five criterion required for a finance lease, meaning the lease does not do any of the following: