PacificCPE

COURSE

21502A

Lessee Lease Classification Under ASC 842

Understanding how lessees classify leases under ASU 2016-02 is essential for accurate financial reporting. This chapter focuses entirely on lessee rules, walking through the criteria that determine whether a lease is classified as a finance lease or an operating lease. Multiple worked examples show how these rules apply in realistic scenarios, making it easier to apply the guidance to your clients' or organization's actual lease arrangements. A practical choice for anyone responsible for lessee-side accounting under the new standard.

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

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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

- Identify a threshold for a lease term to be considered a major part of an asset's remaining economic life.
- Recognize who an entity might not want to use the risk-free rate to compute the present value of lease payments.
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Identify how a lessee should account for initial direct costs.

- Recognize items that are and are not components of a lease term.
- Recall the method a lessee should use to record interest expense on a lease obligation.

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Section 3

Chapter Objective

After completing this chapter, you should be able to:

- Identify a threshold for a lease term to be considered a major part of an asset's remaining economic life.
- Recognize who an entity might not want to use the risk-free rate to compute the present value of lease payments.
- Identify how a lessee should account for initial direct costs.
- Recognize items that are and are not components of a lease term.
- Recall the method a lessee should use to record interest expense on a lease obligation.

VII. LESSEE RULES

A. LEASE CLASSIFICATION - LESSEE

1. ASU 2016-02 requires an entity to classify each separate lease component at the commencement date. In most cases, there is one lease component per lease.
2. Once the classification is done, an entity shall not reassess the lease classification after the commencement date unless:
   a) The lease contract is modified and the modification is not accounted for as a separate contract.
   b) There is a change in the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying leased asset.

Note

ASU 2018-10, *Codification Improvements to Topic 842, Leases*, adds further guidance to ASC 842 with respect to the reassessment of classification of leases. Specifically, the ASU states the following:

When an entity (lessee or lessor) is required to reassess lease classification, the entity shall reassess classification of the lease on the basis of the facts and circumstances (and the modified terms and conditions, if applicable) *as of the date the reassessment is required*.

Example: The basis of facts would include the fair value and the remaining economic life of the underlying asset as of the date there is a change in the lease term, or in the assessment of a lessee option to purchase the underlying asset, or as of the effective date of a modification not accounted for as a separate contract.

3. A lessee shall classify a lease as either a(an):

   Finance lease (Type A lease)- Lessee *expects to* consume a *major part* of the economic benefits of the leased asset.

   Operating lease (Type B lease)- Lessee *does not expect* to consume a *major part* of the economic benefits of the leased asset. An operating lease is defined as any lease that does not qualify as a finance lease.

4. **Finance lease- lessee**

   a) A lease is a *finance lease* if the lessee expects to *consume a major part of the economic benefits* of the leased asset when the lease meets any one of the following *five criteria* at the lease commencement date:

      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 a *major part* of the remaining economic life of the underlying asset.

         1) *75% or more* of the remaining economic life of the underlying asset is a major part of the remaining economic life of that underlying asset.

         Exception: If the commencement date falls within the last 25% of the total economic life of the underlying leased asset, the 75% criterion (Criterion 3) cannot be used for purposes of classifying the lease.

Note

If a single lease component contains the right to use more than one underlying asset, an entity shall consider the remaining economic life of the *predominant asset* in the lease component in computing the 75% test.

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 of the fair value* of the underlying asset.

1) *90% or more of the fair value* of the underlying asset amounts to substantially all the fair value of the underlying asset.

a. ASU 2016-02 is silent as to which interest rate a lessee should use to apply the 90% test.

Absent authority, the lessee should use rates authorized elsewhere within the ASU:

- First, use the rate implicit in the lease, if available.
- Then, use the lessee's incremental borrowing rate.[9]

Note

The ASU states that in some cases, it may not be practicable for an entity to determine the fair value of an underlying asset for purposes of performing the 90% test (Criterion 4). The term "practicable" means that a reasonable estimate of fair value can be made without undue cost or effort. In situations in which it is not practicable for a lessee to determine the fair value of an underlying asset, the lease classification should be determined based on the other four criteria without consideration to the 90% test (Criterion 4).

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.

Below is a brief discussion of each of the five criteria.

Criterion 1: Transfer of ownership criterion

The transfer of ownership criterion (Criterion 1) is met in leases that have language that either:

a. States that upon the lessee's performance in accordance with the terms of the lease, that the lessor should execute and deliver to the lessee such documents (including, if applicable, a bill of sale) as may be required to release the underlying asset from the lease and to transfer ownership to the lessee.

b. Requires the payment by the lessee of a *nominal amount* (for example, the minimum fee required by the statutory regulation to transfer ownership) in connection with the transfer of ownership.

Note
A provision in a lease that ownership of the underlying asset is not transferred to the lessee if the lessee elects not to pay the specified fee (whether nominal or otherwise) to complete the transfer is an option to purchase the underlying asset. Such a provision does not satisfy the transfer-of-ownership criterion (Criterion 1).

Criterion 2: The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise

ASU 2016-02 provides that if a lease has an option to purchase the underlying leased asset and it is *reasonably certain* that the lessee will exercise the option, Criterion 2 is met and the lease is categorized as a finance lease (Type A) lease.

a. The determination of whether the lessee is reasonably certain to exercise the option is made at the commencement date, and not subsequent to the commencement date.

Criterion 3: Lease term is a major part of the remaining economic life of the underlying leased asset

In Criterion 3, ASU 2016-02 applies a *75 percent rule* in determining whether the lease term is a major part of the remaining economic life.

a. Criterion 3 is based on the following overall rule:

If the lease term is *75 percent or more of the remaining economic life* of the underlying asset, the *lease term is considered a major part of the remaining economic life* of the asset. In such a case, Criterion 3 is satisfied and the lease is a finance lease from the lessee's perspective.

In determining the lease term, there are a few rules:

a. The lessee should include any options to extend the lease if it *reasonably certain* the lessee will exercise its option to extend the lease.
b. If the commencement date is within the last 25 percent of the total economic life of the leased asset, Criterion 3 cannot be used to test whether there is a finance lease. Instead, a lessee must use one of the other four criteria.
c. If a lease has several lease components with different remaining economic lives, the lessee should use the remaining economic life of the *most predominant asset* within the lease, to apply to the calculation of the entire lease.

Criterion 4: Present value is 90% or more of the fair value

Criterion 4 states that if the present value of the lease payments (and any residual value not already reflected in the lease payments) is 90 percent or more of the fair value of the leased asset, the lease consumes a major part of the economic benefit of the leased asset. Thus, Criterion 4 is satisfied and the lease is considered a finance (Type A) lease.

a. In determining the present value, lease payments should include the payments of any lease option periods and any option to purchase, if it is *reasonably certain* that the lessee will exercise those options.
b. The present value calculation should include a residual value at the end of the lease term.

Which interest rate should a lessee use in making the 90% present value calculation in Criterion 4?

The ASU does not require that the lessee use the implicit interest rate to make the 90% calculation, although use of the implicit rate is required by the lessor. Absent the requirement to use the implicit interest rate, the author believes it is appropriate to follow the guidance found in the ASU in calculating the lease obligation which is to first use the implicit rate in the lease, if available. If the implicit rate is not available, use the lessee's incremental borrowing rate.

Further on in this course, the author addresses the present value computation of the lease obligation. In that section, the ASU permits use of a risk-free rate (such as the U.S. Treasury rate) for nonpublic lessees in computing the lease obligation. The question is whether a lessee is permitted to use the risk-free rate of return in performing the 90% test (Criterion 4) to determine whether a lease is a finance lease. The ASU is silent on the issue.[10]

Criterion 5: Alternative use

Criterion 5 states that for a lessee, a lease is classified as a finance lease (Type A lease) if the leased 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*.

ASU 2016-02 states that in assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term and the lessor' ability to *readily direct that asset for another use* (such as sell it or lease it to an entity other than the lessee), a lessee should consider the effects of:

- Contractual restrictions, and
- Practical limitations.

The ASU provides the following guidance in making the assessment of alternative use:

a. A contractual restriction on a lessor's ability to direct an underlying asset for another use must be substantive (e.g., enforceable) for the asset not to have an alternative use to the lessor.

b. A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use.

- A significant economic loss could arise because the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss.

  For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas.

ASU 2016-02 states that the possibility of the contract with the lessee (customer) being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.

5. **Operating lease (Type B lease)- lessee**

a) When none of the five criteria to classify a lease as a finance (Type A) lease are met, a lessee shall classify the lease as an *operating (Type B) lease*.

That means an operating lease *fails all of the five criteria* related to a finance lease:

Fails Criterion 1: The lease does not transfer ownership of the underlying asset to the lessee at the end of the lease term.

Fails Criterion 2: The lease does not grant the lessee an option to purchase the leased asset or there is an option to purchase and it is not reasonably certain that the lessee will exercise it at the commencement date.

Fails Criterion 3: The lease term is not 75% or more of the remaining economic life of the leased asset.

Fails Criterion 4: The present value of the lease payments (and any residual value guaranteed by the lessee) is less than 90% of the fair value of the leased asset, and

Fails Criterion 5: The underlying asset is not of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term