PacificCPE

COURSE

21503A

Lessee Accounting Measurement and Recognition

Building on lease classification, this section addresses the measurement and recognition requirements that lessees must apply under ASU 2016-02. Professionals working with clients who hold significant lease portfolios will find this material directly relevant to balance sheet presentation, right-of-use asset calculations, and lease liability determinations. Whether you're advising on implementation or preparing financial statements, mastering these lessee accounting mechanics is a core competency under the new lease 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

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

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Section 4

Chapter Objective

After completing this assignment, you should be able to:

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

E. SHORT-TERM LEASES- LESSEE

A lessee may elect not to capitalize certain *short-term leases* and, instead, account for them the same way in which operating leases are accounted for under existing lease standards.

1. ASU 2016-02 defines a short-term lease as a lease that, at the commencement date:
   a) Has a *lease term of 12 months or less*, and
   b) *Does not include an option to purchase* the underlying asset that the lessee is reasonably certain to exercise.
2. Under the short-term lease rules:
   a) As an accounting policy, a lessee may elect not to apply the recognition requirements in ASU 2016-02 to short-term leases.
   b) Instead, a lessee may do the following:
      1) Recognize the lease payments in the income statement as *rent expense on a straight-line basis* over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.
   c) The accounting policy election for short-term leases shall be made by class of underlying asset to which the right of use relates.
   d) If the lease term or the assessment of a lessee option to purchase the underlying asset changes such that, after the change, the remaining lease term extends more than 12 months from the end of the previously determined lease term or the lessee is reasonably certain to exercise its option to purchase the underlying asset, the lease no longer meets the definition of a short-term lease and the lessee shall apply the ASU 2016-02 immediately as if the date of the change in circumstances is the commencement date.

Example 1: Short-Term Lease

Lessee enters into a 12-month lease of a vehicle, with an option to purchase the asset at the end of the lease. Monthly payments are $5,000 (total of $60,000 for the 12-month lease period).

Lessee has considered all relevant factors and determined that it is *not reasonably certain to exercise the option* to purchase.

Lessee seeks to make an accounting policy election not to recognize a right-of-use asset and lease obligation that arise from short-term lease.

Conclusion:

Lessee can make the *short-term lease policy election* not to recognize the right-of-use asset and liability obligation.

The lease qualifies as a short-term lease for two reasons:

a. At the lease commencement, it is *not reasonably certain that the lessee will exercise the option* to purchase, and
b. The lease term is 12 months or less.

The lease meets the definition of a short-term lease because the lease term is 12 months or less and it is not reasonably certain that any option to purchase will be exercised. Consequently, consistent with Lessee's accounting policy election, Lessee does not recognize the right-of-use asset and the lease liability arising from this lease. Instead, each month, Lessee makes the following entry:

Entry each month:	dr	cr
Rent expense	5,000	
Cash, AP		5,000

To record monthly rent

Example 2: Short-Term Lease

Same facts as Example 1, except that at the lease commencement date, it is reasonably certain that the lessee will exercise its option to purchase.

Conclusion:

The lease does not qualify as a short-term lease. Even though the lease term is 12 months or less, it is reasonably certain that the lessee will exercise its option to purchase.

Having an option to purchase where it is reasonably certain, at the commencement date, that the lessee will exercise the option to purchase, disqualifies the lease for short-term lease treatment.

Thus, the lease is not exempt from the ASU 2016-02 rules and a right-of-use asset and lease obligation must be recorded as either a finance lease (Type A) or an operating lease (Type B).

Example 3: Short-Term Lease

Lessee enters into a 12-month lease of a vehicle, with an option to extend for another 12 months.

There is no option to purchase in the lease.

Monthly payments are $5,000 (total of $60,000 for the 12-month lease period).

Lessee has considered all relevant factors and determined that it is *not reasonably certain to exercise the option* to extend.

Lessee seeks to make an accounting policy election not to recognize a right-of-use asset and lease obligation that arise from short-term lease.

Conclusion:

Because, at lease commencement, Lessee is not reasonably certain to exercise the option to extend, the lease term is 12 months.

The lease meets the definition of a short-term lease because the lease term is 12 months and there is no lease option to purchase.

Consequently, consistent with Lessee's accounting policy election, Lessee does not recognize the right-of-use asset and the lease liability arising from this lease. Instead, each month, Lessee makes the following entry:

Entry each month:	dr	cr
Rent expense	5,000	
Cash, AP		5,000

To record monthly rent

Example 4: Short-Term Lease

Same facts as Example 3, except that six months into the lease, Lessee decides it is reasonably certain it will exercise its option to extend by another 12 months.

Conclusion:

Once it is reasonably certain it will exercise the 12-month option to extend the lease, the lease term is now 18 months (6 months remaining plus 12-month option to extend). Thus, the lease no longer qualifies as a short-term lease.

ASU 2016-02 states that if the lease term changes, such that after the change the remaining lease term extends more than 12 months from the end of the previously determined lease term, the lease no longer meets the definition of a short-term lease.

On the date on which it is reasonably certain that the lessee will exercise the option to extend, the lessee should apply the lease requirements in ASU 21016-02. That means it should classify the lease (finance versus operating), and record a right-of-use asset and lease obligation. Moving forward, it should record interest and amortization at amounts depending on the classification of the lease.

Observation

Most short-term leases do not have lease options so that they are either tenants at will or 12-month leases. In such situations, it is likely that the lease is a short-term lease and that no recording of a lease asset and liability is needed. With respect to related-party leases, it is easy to avoid the new lease standard by ensuring that all related party leases are either tenant at will arrangements or 12-month leases. Moreover, if there is no formal lease agreement, the lease is a tenant-at-will arrangement to which the short-term lease exception applies.

ASU 2023-01- Common Control Arrangements and Month-to-Month Leases

In this section, the author addresses an important modification to the lease standard made by ASU 2023-01, *Leases (Topic 842)- Common Control Arrangements*. The changes made by the ASU were needed to address a significant degree of confusion surrounding related-party (common control) leases, particularly those that are month-to-month, unwritten arrangements.

As we reviewed previously, when an entity has a short-term lease (12 months or less with no options to extend), the rules in ASU 2016-02 (ASC 842) are quite clear that the lessee:

1. May make an accounting policy election not to recognize the lease asset and obligation on the balance sheet, and
2. Recognizes the lease payments in the income statement as *rent expense on a straight-line basis* over the lease term.

This 12-month rule applies if there is a lease of 12 months or less with a related or unrelated party lessor.

But what happens when there is an unwritten month-to-month lease arrangement with a related party?

In closely held arrangements, it is common for a lessee to rent office or warehouse space from a common controlled lessor. Because these leases may continue from month to month in perpetuity, they are typically called evergreen leases because they automatically rollover from month to month until either the lessee or lessor unilaterally terminates the lease.

In the previous illustration, Company Y is a lessee who rents/leases space from its common controlled lessor (Company X) under a month-to-month arrangement. Assume further there is no consolidation under the variable interest entity (VIE) rules in ASC 810.

Is Company Y (lessee) permitted to treat this month-to-month lease as a short-term lease (12 months or less) so that Y may elect to not capitalize this lease under the new lease standard?

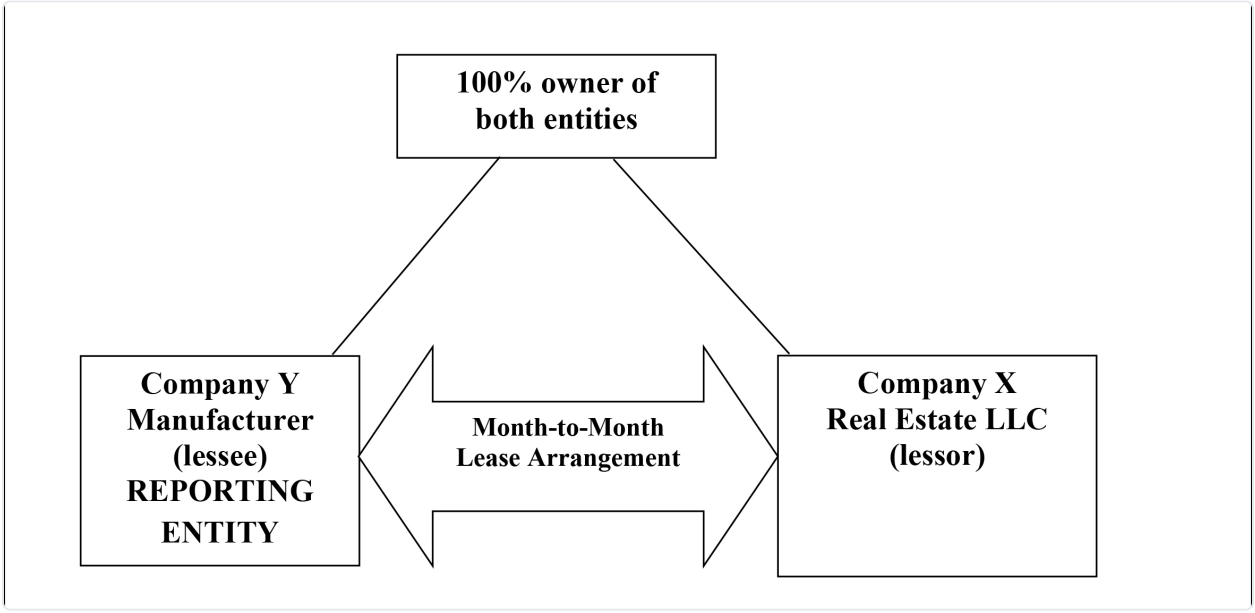
On its face, the answer should be "yes." However, there is an obstacle that Y must get through first.

ASC 842-10-55-23 states:

> "An entity should determine the noncancellable period of a lease when determining the lease term. When assessing the length of the noncancellable period of a lease, an entity should apply the definition of a contract and determine the period for which the contract is *enforceable*.
>
> A lease is no longer *enforceable* when both the lessee and the lessor each have the right to terminate the lease without permission from the other party with **no more than an insignificant penalty**."

ASC 842-10-55-24 further states:

> "If only a lessee has the right to terminate a lease, that right is considered to be an option to terminate the lease available to the lessee that an entity considers when determining the lease term, as described in paragraph 842-10-30-1. If only a lessor has the right to terminate a lease, the noncancellable period of the lease includes the period covered by the option to terminate the lease."



The guidance in ASC 842-10-55-23 has created confusion as to how to apply it to related-party (common controlled) leases which may be month-to-month arrangements, and written or unwritten.

In such instances, both the lessee and lessor each have the right to terminate the lease without permission of the other party. But the second issue is whether there would be an insignificant penalty for doing so. That is, if there is a month-to-month arrangement, if the lessee were to terminate with a 30-day notice, would there be an insignificant penalty to the lessee for such termination? If there is no more than an insignificant penalty for the lessee to terminate, the lease term is enforceable for only 30 days and the short-term lease rule may be applied, with the lessee being able to avoid capitalizing the lease. ASC 842 does not define "insignificant penalty." But, ASC 842-10-20 does define "penalty" to mean:

Any requirement that is imposed or can be imposed on the **lessee** by the **lease** agreement or by factors outside the lease agreement to do any of the following:

a. Disburse cash

b. Incur or assume a liability

c. Perform services

d. Surrender or transfer an asset or rights to an asset or otherwise forego an economic benefit, or suffer an economic detriment. Factors to consider in determining whether an economic detriment may be incurred include, but are not limited to, all of the following:

- The availability of a comparable replacement asset
- The relative importance or significance of the underlying asset to the continuation of the lessee's line of business or service to its customers
- **The existence of leasehold improvements or other assets whose value would be impaired by the lessee vacating or discontinuing use of the underlying asset**
- Adverse tax consequences, and
- **The ability or willingness of the lessee to bear the cost associated with relocation** or replacement of the underlying asset at market rental rates or to tolerate other parties using the underlying asset.

The author suggests that the key element within this list is *"existence of leasehold improvements… whose value would be impaired by the lessee vacating or discontinuing use of the underlying asset."*

This language has created havoc and differing opinions among so-called "industry experts."

Some have taken the position that if there is a month-to-month lease between related parties so that either the lessee or lessor may terminate with a 30-day notice (clearly 12 months or less lease term) and that if the lessee would be required to leave behind more than an "insignificant amount of

leasehold improvements,"[18] the arrangement is "enforceable" beyond the 30-day period. Thus, in such a situation, the lease is not a one-month arrangement and instead, the lessee must evaluate how long it is "reasonably certain" to occupy the leased premises. If it is "reasonably certain" that the lessee expects to occupy the premises for more than 12 months, the lease is deemed enforceable for more than 12 months and is not a short-term lease. Let's review a few examples showing the challenges that exist and why ASU 2023-01 was needed to resolve them: