PacificCPE

COURSE

21504A

Lessor Accounting Rules and Lease Classification

Shift to the other side of the transaction with a focused look at lessor accounting under ASU 2016-02. This course explains how lessors classify leases as sales-type or operating, compares those classifications across typical asset types, and contrasts lessor treatment with the lessee rules covered elsewhere in the series. A helpful comparison table ties together both sides of the lease relationship, giving practitioners a clearer picture of how the standard affects clients who lease assets to others.

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 types of leases for a lessor.
- Recognize the rate that a lessor should use in performing the 90% test for a direct financing lease.
- Recall how a lessor should initially account for initial direct costs for a lease in certain instances.
- Identify how a lessor should account for lease payments received on the income statement for an operating lease.
- Recall how a lessor should classify certain cash receipts on the statement of cash flows.

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Section 5

Chapter Objective

After completing this chapter, you should be able to:

- Identify types of leases for a lessor.
- Recognize the rate that a lessor should use in performing the 90% test for a direct financing lease.
- Recall how a lessor should initially account for initial direct costs for a lease in certain instances.
- Identify how a lessor should account for lease payments received on the income statement for an operating lease.
- Recall how a lessor should classify certain cash receipts on the statement of cash flows.

VIII. LESSOR RULES

A. LEASE CLASSIFICATION

From the lessor's perspective, the ASU 2016-01 provides three potential types of leases:

- Sales-type lease
- Direct financing lease, or
- Operating lease.

Sales-type lease:

ASU 2016-02 uses the *same five criteria used by a lessee* to classify a finance (Type A) lease, in assessing whether a sales-type lease exists for a lessor.

1. A lessor's lease is a sales-type lease if the lessee is expected to *consume a major part of the economic benefits* (life) 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.

a) *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 shall not 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.

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

- A lessor shall compute the present value using the rate implicit in the lease.
- A lessor shall assume that no initial direct costs will be deferred if, at the commencement date, the fair value of the underlying asset is different from its carrying amount.

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.

Direct financing lease:

When none of the five criteria to classify a lease as a sales-type lease are met, a lessor shall classify the lease as either a (an):

- Direct financing lease, or
- Operating lease.

1. If the lease is not a sales-type lease, it is classified as a direct financing lease if two criteria are met:

a) 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 *and/or any other third party unrelated to the lessor* equals or exceeds substantially all of the fair value of the underlying asset.

- 90% or more of the fair value of the underlying asset amounts to substantially all the fair value of the underlying asset.

- A lessor shall compute the present value using the rate implicit in the lease.

b) It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Note

Unlike a lessee, a lessor is required to use the rate implicit in the lease to perform its 90% test. A lessee may use the implicit rate, if known, or its incremental borrowing rate.

2. In general, a direct financing lease is the same as a sales-type lease except for two differences that are summarized as follows:
   a) A direct financing lease defers any selling profit and includes it in the measurement of the net investment in the lease. A sales-type lease recognizes selling profit into income at the commencement of the lease.
   b) A direct financing lease defers initial direct costs and records them as part of the net investment in the lease while a sales-type lease expenses such costs in most cases.

Observation

There is a 90% present value test (Criterion 4) that is used to determine if a lease is a sales-type lease. If not a sales-type lease, it is either a direct financing lease or an operating lease. A lease is a direct financing lease if two conditions are met:

- 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 *and/or any other third party unrelated to the lessor* equals or exceeds substantially all (90% or more) of the fair value of the underlying asset, and
- It is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.

Are the two 90% present value computations the same?

No. The 90% present value test used to determine if a lease is a direct financing lease computes present value using the sum of the lease payments and any residual value guaranteed by:

- The lessee that is not already reflected in the lease payments, and/or
- Any other third party unrelated to the lessor.

The 90% present value computation used to determine if there is a direct financing lease has part (b), which is to include the present value of any residual value guaranteed by "any third party unrelated to the lessor."

The 90% test for a sales-type lease does not include any residual value guaranteed by a third party unrelated to the lessor.

Operating lease:

From a lessor's perspective, if the lease does not qualify as a sales-type lease (Type A) and does qualify as a direct financing lease, it defaults to an operating lease.

1. Under the operating lease rules, a lessor:
   a) Applies an approach *similar to existing operating lease* accounting in which the lessor does the following:
      - Retains the leased asset on the lessor's balance sheet, and
      - Recognizes lease (rental) income over the lease term typically on a straight-line basis.

Comparison of Lessor Lease

Sales-Type vs. Operating Lease

Sales-Type Lease	Operating Lease
Lessee is *expected to* consume a *major part* of the economic benefits of the leased asset.	Lessee is **not expected** to consume **a major part** of the economic benefits of the leased asset.
Satisfies one or more of 5 criteria at the commencement date	**Does not satisfy any of the 5 criteria at the commencement date**
• **Criterion 1:** Lease transfers ownership	• **Criterion 1:** Lease transfers ownership **FAILED**
• **Criterion 2:** Lease grants lessee option to purchase that lessee is reasonably certain to exercise	• **Criterion 2:** Lease grants lessee option to purchase that lessee is reasonably certain to exercise- **FAILED**
• **Criterion 3:** Lease term is 75% or more of the remaining life	• **Criterion 3:** Lease term is 75% or more of the remaining life- **FAILED**
• **Criterion 4:** Present value is 90% or more of fair value	• **Criterion 4:** Present value is 90% or more of fair value- **FAILED**
• **Criterion 5:** Leased asset is a specialized nature with no alternative use	• **Criterion 5:** Leased asset is a specialized nature with no alternative use- **FAILED**
Most equipment leases	**Most real estate leases**

Note

If a lease fails all five of the criteria for a sales-type lease, it is classified as an operating lease by the lessor.

Comparison of Treatment of

Sales-Type vs. Operating Leases for Lessors

Sales-Type Lease	Operating Lease
Lessor effectively transfers control to the lessee.	Lessor does not effectively transfer control to lessee
Lessor derecognizes (removes) the underlying fixed asset that is leased.	The fixed asset that is leased is retained on the books of the lessor and depreciated.
Lessor records a new lease asset (net investment in lease) consisting of two elements: • A lease receivable, and • An unguaranteed residual asset.	There is no recording of a net investment in the lease asset or profit/loss arising from the lease.
At commencement, lessor records a selling profit or loss arising from the lease.[33] Interest income is recognized over the lease term.	Lease (rental) income: • Recorded to income on lessor's income statement on a straight-line basis over the lease term.
Variable lease payments received: if not included in the net investment in the lease, should be recorded as income in the period when the changes in facts and circumstances on which the variable lease payments are based occur.	Variable lease payments received: are recorded in income in the period in which the changes in facts and circumstances on which the variable lease payments are based occur.
Initial direct costs are expensed, if, at the commencement date, the fair value of the leased asset differs from the carrying amount.	Initial direct costs are deferred and recorded to expense over the lease term on the same basis as lease income.
Cash received from leases is part of operating activities.	Cash received from leases is part of operating activities (rental income part of net income).