Lease Accounting – The State of Play

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Lease accounting is a catch-all term for the variety of methods used to account for leases in a company's financial statements. The history of lease accounting goes back to the early 20th century, when leases were first recognized as a form of financing. Naturally, the complexity of the topic has increased as the kinds of financing available have become more sophisticated.

In the middle of the twentieth century, accounting for leases was still relatively simple. Leases were classified as either operating or capital leases, with operating leases being recorded as expenses on the income statement (e.g., rental costs) and capital leases being recorded as both assets and liabilities on the balance sheet.

This method of lease accounting was criticized, however, for allowing companies to keep leases off their balance sheets and thereby understating their debt. The airline industry came in for particular attention for this policy with many airlines not having any airplanes on their balance sheets.

A History of Lease Accounting under US GAAP up to the 2010s

In 1976, in an early attempt to address the issue, the Financial Accounting Standards Board (FASB) issued Statement 13 (which later became ASC840 in the Accounting Standards Codification) that required companies to recognize leases with a term of more than 75% of the asset's economic life as capital leases.

In the 1980s, the FASB began working on a comprehensive project to revise accounting for leases. An updated Statement 13, which was issued in 1984, retained the distinction between operating and capital leases, and required companies to recognize capital leases as both assets and liabilities on the balance sheet.

Unfortunately, this new standard failed to fully address the concerns about leases being off balance sheet, and the general sentiment at the time was that this still did not provide sufficiently useful information to financial statement users.

In the 1990s, the FASB started to work on a new lease accounting standard, resulting in further updated Statement 13, which superseded the previous standard in 1998. This version, however, still did not change the fundamental characteristic of lease accounting. While it required more information about leases to be disclosed in financial statements, many felt it did not require the disclosure of the whole picture of a company's leases.

A History of Lease Accounting under International Accounting Standards up to the 2010s
Outside the US, Internal Accounting Standard (IAS) 17: "Leases" was an international accounting standard issued by the International Accounting Standards Board (IASB) that provided guidance on how lessees and lessors should account for leases in their financial statements. The standard (which generally applied to non-US GAAP entities) was first issued in 1985 and, as with Statement 13/ASC 840, was subsequently amended several times over the years.

Under IAS 17, lessees were required to classify leases as either finance leases or operating leases. Finance leases were leases in which the lessee assumed substantially all of the risks and rewards of ownership of the leased asset, and were required to be recognized as assets and liabilities on the balance sheet. Operating leases, on the other hand, were leases in which the risks and rewards of ownership were retained by the lessor, and were not required to be recognized as assets or liabilities on the balance sheet. Instead, the lessee recognized lease payments as an expense on the income statement over the lease term.

As with Statement 13/ASC 840, IAS 17 was criticized for providing a less than transparent view of a company's lease obligations and assets. The standard allowed companies to keep operating leases off-balance sheet, which resulted in an understated view of liabilities and assets.

A Collaboration on A New Way to Account for Leases
In the early 2010s, the FASB and the IASB began a joint project to develop new lease accounting standards (ASC 842 and IFRS 16) that are both the most recent and the most comprehensive standard for accounting for leases that would bring leases onto the balance sheet. In 2013, they issued exposure drafts of new standards, IFRS 16 and ASC 842, to replace IAS 17 and ASC 840, respectively.

These new standards require companies to recognize almost all leases as both an asset and a liability on the balance sheet and also provide more detailed disclosures about leases in the financial statements. Both standards are seen as significant improvements over their previous versions as they provide a more accurate picture of a company's lease obligations, as well as improving comparability across companies. IAS 17 was superseded by IFRS 16 on January 1, 2019 and is considered withdrawn as of then. ASC 842 became effective for public companies for fiscal years beginning after December 15, 2018. The initial effective date for private companies was for fiscal years beginning after December 15, 2019 although this was delayed several times by the FASB but is now in force for any fiscal years starting after December 15, 2021.

The roll-out of IFRS 16, the international accounting standard for leases, has varied across different countries and regions. In the European Union, all member states are required to adopt IFRS standards, including IFRS 16, so the standard has been fully adopted across the region.

In Asia, many countries have adopted IFRS 16, including Japan, South Korea, China, Hong Kong and Singapore. The adoption of IFRS standards is not mandatory in all Asian countries, however, and some countries such as India have their own accounting standards.

In Africa, most countries have adopted IFRS 16, but some countries still use their own accounting standards. In Oceania, most countries have adopted IFRS 16, but again, some countries still use their own accounting standards.

In South America, the adoption of IFRS 16 varies by country; for example, Argentina, Chile, and Colombia have adopted the standard, but other countries such as Brazil, Mexico and Peru still use their own accounting standards.

It's worth noting that the new standards are not without criticism in that they have brought new challenges to the companies that are required to report under them. In particular, in many cases they require significant effort to upgrade accounting systems, processes and technology to gather the necessary data, undertake complex calculations and maintain the required records.

In summary, the history of lease accounting has been one of ongoing efforts to improve the information provided to financial statement users by bringing leases onto the balance sheet and requiring more detailed disclosures. The current challenges in implementing them, are seen as significant improvements over previous standards.

Detail of Current Accounting Standards for Leases Under US GAAP – ASC842

As noted above, ASC 842 is the accounting standard issued by the FASB that outlines how lessees and lessors should account for leases in their financial statements. The standard was issued in February 2016 and started to become effective in fiscal years beginning after December 15, 2018.

ASC 842 replaced ASC 840 Leases, which had different accounting requirements for finance leases and operating leases. As referred to above, one of the biggest changes under ASC 842 is that lessees are required to recognize a lease liability and a right-of-use asset for all leases, including operating leases, with a term of more than 12 months. This means that lessees must bring operating leases on to the balance sheet, which will increase the assets and liabilities reported. To be clear on the change this represents, these kinds of operating leases had previously been treated as operating expense items in most company's financial statements.

Under ASC 842, the reported lease liability on the balance sheet should represent the lessee's obligation to make lease payments, while the right-of-use asset represents the lessee's right to use the leased asset during the lease term.

The right-of-use asset is measured at the lease liability, plus any upfront lease payments, and is then amortized over the lease term in a manner similar to how assets that are "owned" have been traditionally depreciated.

Under ASC 842, lessees are required to recognize the lease liability at the present value of the lease payments, discounted at the lessee's incremental borrowing rate. Lessees are also required to apply the requirements of ASC 842 retrospectively, meaning that lessees are required to restate their lease accounting for all years presented in the financial statements as if ASC 842 had always been in effect.

As for lessors, they are required to classify their leases as either sales-type leases, direct financing leases or operating leases. Sales-type leases and direct financing leases are accounted for in a similar manner to that under ASC 840, and the lessor recognizes an asset (the lease receivable) and a liability (the unearned finance income) from these leases.

Operating leases are not recognized as assets or liabilities on the balance sheet. Instead, the lessor recognizes lease income over the lease term, typically on a straight-line basis. As with lessee accounting, under ASC 842, lessors are required to apply the new standard retrospectively, which means that they will be required to restate their lease accounting for all years presented in the financial statements as if ASC 842 had always been in effect.

In summary, ASC 842 requires lessees to recognize right-of-use assets and lease liabilities on their balance sheets for all leases with a term of more than 12 months. This will generally result in increased assets and liabilities reported on the balance sheet, and provide a more accurate picture of a lessee's lease obligations and assets.

Current Accounting Standards for Leases under International Financial Reporting Standards – IFRS16

IFRS 16 is the international accounting standard for leases that was issued by the International Accounting Standards Board in 2016 following the consultation described above. IFRS 16 is mandatory for all companies that report under International Financial Reporting Standards (IFRS) and is effective for annual periods beginning on or after January 1, 2019.

The requirements under IFRS 16 are broadly the same as for those under ASC 842 in that lessees are required to recognize a lease liability and a right-of-use asset for all leases, including operating leases, with a term of more than 12 months. This means that lessees must bring operating leases on to the balance sheet, which will increase the assets and liabilities reported on the balance sheet.

The lease liability represents the lessee's obligation to make lease payments, while the right-of-use asset represents the lessee's right to use the leased asset during the lease term. The right-of-use asset is measured at the lease liability, plus any upfront lease payments, and is then depreciated over the lease term.

As with ASC 842, IFRS 16 requires lessees to recognize the lease liability at the present value of the lease payments, discounted at the interest rate implicit in the lease or, if that rate cannot be determined, at the lessee's incremental borrowing rate. Lessees are also required to apply the requirements of IFRS 16 retrospectively, meaning that lessees will be required to restate their lease accounting for all years presented in the financial statements as if IFRS 16 had always been in effect.

Some example calculations

By way of example, let's say that a company, XYZ Inc., enters into a lease agreement to rent a warehouse for a term of five years. The lease requires XYZ Inc. to pay $1,000 per month in rent, with the first payment due at the start of the lease. The lease also requires XYZ Inc. to pay for all operating expenses, such as property taxes and insurance, associated with the warehouse.

Under the new rules, XYZ Inc. would be required to recognize a lease liability and a right-of-use asset on its balance sheet. The lease liability would be the present value of the lease payments over the five-year lease term, discounted at the interest rate implicit in the lease or, if that rate cannot be determined, at XYZ Inc.'s incremental borrowing rate.

Let's assume that the lease has an implicit interest rate of 6%. The present value of the lease payments over five years would be calculated as follows:

Month	Payment	Discounted value
1	1,000	1,000

2	1,000	995
..		
60	1,000	745
TOTAL	**60,000**	**51,967**

So, the lease liability would be recorded as $51,967. The right-of-use asset would be recorded as $51,967 + any additional upfront lease payments (if any).

Throughout the five-year lease term, XYZ Inc. would be required to recognize a lease expense on its income statement, which would be calculated as the difference between the lease payments and the interest on the lease liability. XYZ Inc. would also be required to depreciate the right-of-use asset over the lease term, reducing the asset value over time. Let's see what those journal entries would look like:

At the start of the term

When the lease is set up, assuming no additional up-front payments, the required journals would be:

Dr Right of Use Asset 51,967
Cr Lease liability* 51,967

* Note this would usually be split between current and non-current liabilities

At the end of month one, the asset would be depreciated by a monthly amount of depreciation (51,967*20%*31/365 = $883) and the first month's payment would be recognized in the journals as follows:

Dr Depreciation expense 883
Cr Accumulated Depreciation 883
Dr Lease liability 1,000
Cr Lease payment 1,000

In following months, the lease payment is split across the reduction in lease liability and the amount of interest for the relevant month, e.g., in month 2, the second part of the journal would be:

Dr Lease liability 995
Dr Interest expense 5
Cr Lease payment 1,000

At the end of the lease term, the right-of-use asset would be fully depreciated and the lease liability would be fully settled.

At AssetAccountant™, we automate all of these calculations for our users who enter their lease data and the system calculates the required entries over the life of the lease and outputs the journals.

Acquired	First Used	Cost	Accumulated Depreciation	Written Down Value
1 Jan 2023	1 Jan 2023	$51,967.10	($5,154.00)	$46,813.10
			at 30 June 2023	at 30 June 2023

Expand All | Collapse All | Show Reversals | Hide Reversals

		Asset			Lease		
Date	Type	Cost	Depreciation	Book Value	Principal	Interest	Lease Liability
1 Jan 2023	Lease Entered	$51,967.10	-	$51,967.10	$51,967.10	$0.00	$51,967.10
1 Jan 2023	First Use	-	-	-	-	-	-
1 Jan 2023	Lease Payment	-	-	-	($1,000.00)	-	$50,967.10
31 Jan 2023	Interest Accrual	-	-	-	-	$4.92	$50,972.02
31 Jan 2023	Depreciation	-	($882.73)	$51,084.37	-	-	-
1 Feb 2023	Interest Accrual	-	-	-	-	$0.16	$50,972.18
1 Feb 2023	Lease Payment	-	-	-	($994.92)	($5.08)	$49,972.19
28 Feb 2023	Interest Accrual	-	-	-	-	$9.31	$49,981.49

Acquired	First Used	Cost	Accumulated Depreciation	Written Down Value
1 Jan 2023	1 Jan 2023	$51,967.10	($5,154.00)	$46,813.10
			at 30 June 2023	at 30 June 2023

Expand All | Collapse All | Show Reversals | Hide Reversals

		Asset	Lease		
Date	Type	Book Value	Principal	Interest	Lease Liability
1 Jan 2023	Lease Entered	$51,967.10	$51,967.10	$0.00	$51,967.10
1 Jan 2023	First Use	-	-	-	-
1 Jan 2023	Lease Payment	-	($1,000.00)	-	$50,967.10
31 Jan 2023	Interest Accrual	-	-	$4.92	$50,972.02
31 Jan 2023	Depreciation	$51,084.37	-	-	-
1 Feb 2023	Interest Accrual	-	-	$0.16	$50,972.18
1 Feb 2023	Lease Payment	-	($994.92)	($5.08)	$49,972.19

Generate Payment Schedule

Amount Financed
$

Interest Rate (if known)
6 %

Starting Interest
$ 0

Fror

Date *
01/01/2023

Lease Payment *
$ 1000

Other Payment
$

Frequency *
Monthly

Q

+ Add Payments

Generate Schedu

Calculated Interest Rate
6.183131%

Date	Principal	Interest
1 Jan 2023	$1,000.00	$0.00
1 Feb 2023	$994.92	$5.08
1 Mar 2023	$990.35	$9.65
1 Apr 2023	$985.32	$14.68
1 May 2023	$980.47	$19.53
1 June 2023	$975.49	$24.51
1 July 2023	$970.69	$29.31
1 Aug 2023	$965.75	$34.25
1 Sept 2023	$960.85	$39.15
1 Oct 2023	$956.12	$43.88
1 Nov 2023	$951.26	$48.74
1 Dec 2023	$946.58	$53.42
1 Jan 2024	$941.77	$58.23

Current Lease Liability Show Details	Current Lease Liability	$1,000.00	$0.00	AA - Leases
Lease Payment Clearing Show Details	Lease Payment Clearing	$0.00	$1,000.00	AA - Leases
Cost Show Details	Cost	$51,967.10	$0.00	AA - Leases
Current Lease Liability Show Details	Current Lease Liability	$0.00	$12,000.00	AA - Leases
Non Current Lease Liabilit Show Details	Non Current Lease Liability	$0.00	$48,000.00	AA - Leases
Current Unexpired Interes Show Details	Current Unexpired Interest	$322.22	$0.00	AA - Leases
Non Current Unexpired Ir Show Details	Non Current Unexpired Interest	$7,710.68	$0.00	AA - Leases
ases		**$61,000.00**	**$61,000.00**	
		$61,000.00	**$61,000.00**	

Journal Date	Group	Account Type	GL Account	Debit	Credit	Description
01/01/2023	Leases	Current Lease Liability	Current Lease Liability	1,000.	-	AA - Leases: Lease Payment from 1 July 2022 to 1 January 2023
01/01/2023	Leases	Lease Payment Clearing	Lease Payment Clearing	-	1,000.	AA - Leases: Lease Payment from 1 July 2022 to 1 January 2023
01/01/2023	Leases	Cost	Cost	51,967.	-	AA - Leases: New Leases from 1 July 2022 to 1 January 2023
01/01/2023	Leases	Current Lease Liability	Current Lease Liability	-	12,000.	AA - Leases: New Leases from 1 July 2022 to 1 January 2023
01/01/2023	Leases	Non Current Lease Liability	Non Current Lease Liability	-	48,000.	AA - Leases: New Leases from 1 July 2022 to 1 January 2023
01/01/2023	Leases	Current Unexpired Interest	Current Unexpired Interest	322.	-	AA - Leases: New Leases Unexpired Interest from 1 July 2022 to 1 January 2023
01/01/2023	Leases	Non Current Unexpired Interest	Non Current Unexpired Interest	7,711.	-	AA - Leases: New Leases Unexpired Interest from 1 July 2022 to 1 January 2023

Conclusion

As has been outlined, lease accounting has had a long and complex history mirroring the nature of the transactions it seeks to report. The latest iterations of the relevant accounting standards, compliance burden aside, are generally viewed as an improvement on previous disclosures. However, one thing that seems certain is that the area will continue to evolve in future years as IFRS16 and ASC 842 become broadly adopted and further enhancements are identified.