Accounting for Leases and Credit Losses Under the CECL Model for Lessors of Real Estate

Lessons Learned

The 2023 audit year has concluded and the 2024 audit interim period has begun. It is now time to reflect on some interesting crossovers between the leasing standard under Financial Accounting Standards Board (“FASB”) Accounting Standard Codification (“ASC”) 842 “Leases”[1] and the Current Expected Credit Loss (“CECL”) Model under FASB ASC 326 “Financial Instruments — Credit Losses.”[2]

ASC 326 went into effect for all private companies and public companies that meet the U.S. Securities and Exchange Commission’s definition of smaller reporting companies with fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. Initially, most lessors believed that ASC 326 would have no impact on their accounting for leases, as the guidance specifically excludes operating lease receivables accounted for under ASC 842 (ASC 326-20-15-3).[3] However, ASC 326-20-15-2 Scope and Scope Exceptions clarifies that the CECL Model is applicable to a lessor’s net investment in a sales-type or direct financing lease accounted for under ASC 842.[4] Additionally, for a sale-and-leaseback transaction where the transfer of the asset is not considered a sale and the transaction is accounted for as a financing by the lessor, amounts paid by the lessor are considered a financing receivable and fall within the scope of ASC 326-20 Measured at Amortized Cost.[5]

Applying ASC 326

The rationale for including sales-type or financing leases under ASC 326 is that when a lease under ASC 842 is determined to be a sales-type or financing lease, the underlying real estate asset is either derecognized or not recorded at all. Instead, the lessor records an investment in a sales-type or financing lease. These investments, now recorded on the balance sheet, are treated more like financial instruments than leases, with both an interest and principal reduction component, but no rental income component.

To further complicate the application of ASC 326, ASC 842-10-15-28 and ASC 840-10-15-29 Separating Components of a Contract also state that if a lease contract covers both land and other assets (i.e., building), the lessor may need to bifurcate the lease into two different lease components with two different lease types.[6] When a lessor enters into this type of lease contract, the two primary tests for the classification of a lease as a sales-type or finance lease under ASC 842-10-25-2 Lease Classification are:

— the lease is for a major part of the remaining economic life of the underlying assets, and

— the present value of the sum of lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying assets.[7]

If either of the above tests is met, the lease will be classified as either a sales-type or finance lease, based on additional considerations.

For example, land is deemed to have an infinite economic life, while a building is generally determined to have a 40- to 50-year economic life. If the lease term is 40 years, such lease would not be for a major portion of the remaining economic life of the land; however, for the building, the same lease could be for a major portion of the building's remaining economic life. As such, the classification of the building component of the lease could be either a sales-type or financing lease, subject to the CECL Model under ASC 326, while the land portion of the lease is deemed to be an operating lease and is not subject to the CECL Model. Therefore, a single lease contract could be subject to two different loss models at each balance sheet date, under both ASC 842 and ASC 326. The land subject to an operating lease should be assessed for impairment under ASC 360 Property, Plant and Equipment, while the building component of the lease would be subject to the CECL Model.

Evaluation of leases under ASC 842 and ASC 326 requires technical accounting knowledge and can be quite complex. FTI Consulting, Inc., can provide accounting advisory and consulting services surrounding the application of both the leasing standard and CECL Model.

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Endnotes

[1] Accounting Standards Update No. 2016-02 – Leases (Topic 842), Financial Accounting Standards Board, February 15, 2016, and as amended, https://asc.fasb.org/1943274/2147479211.

[2] Accounting Standards Update No. 2016-13 – Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, Financial Accounting Standards Board, June 16, 2016, and as amended, https://asc.fasb.org/1943274/2147479534.

[3] Ibid.

[4] Ibid.

[5] Ibid.

[6] Accounting Standards Update No. 2016-02 – Leases (Topic 842), Financial Accounting Standards Board, February 15, 2016, and as amended, https://asc.fasb.org/1943274/2147479211.

[7] Ibid.