Leases impacted by Current Economic Context: Lessees under contracts with purchase option

By Pablo Lutenberg*

The accounting lease rules changed and were adopted by public companies in 2019. As a consequence, the majority of the lease contracts greater than one year are now reflected in the balance sheet.

Leases current context

The ruling (specified in ASC 842) provided guidance on how to implement this new accounting lease procedures. Incorporation in the Balance Sheet of the required contracts was done based on the regulation which defined the required notions for the assessment: categorize contract components as lease and non-lease, classify lease components (for lessees either finance or operating, while lessors must classify leases as sales-type, direct financing, or operating leases) and measure and recognition of the lease (recognition of asset and liability).

For the case of lessees with contracts containing an option to purchase, they have reflected in their financials a value (asset and liability) based on their plan of when that option was going to be exercised. In other words, the value reflected in the balance sheet reflects the timing of when the company anticipated the end of the lease period given its plan to purchase the asset.

At the same time, driven by the Covid-19 impact, we are currently in the midst of a worldwide economic downturn where fears are growing that it could be deep and lengthy. In this current context the Federal Reserve has repeatedly stated that would keep its benchmark interest rate near zero for as long as it takes until the economy starts to recover from the coronavirus crisis. The low financing cost for corporations greatly influence their cash flow management.

Lessees' situation

Based on the above, companies that have entered in contracts as lessees to get the right of use of an asset, with payments tied to floating indexes (in a market with bottom low rates showing no signs of an increase any time soon) and with an option to purchase that asset in the future, have recorded the lease based on their planned timing for exercising that purchase option. In many cases, at time of inception, they expected to buy in the short or mid-term. The amounts recorded in their balance sheet are the reflection of the timing and amount of that assumption at the start of the lease.

However, given the current economic context where many companies are shifting their priorities and closely looking at cash flow management in an environment of low financing cost, many corporations will surely reassess their original purchase plan. A big disbursement may not make sense in the short/mid-term (or even to exercise the purchase option at all), especially in this low-cost financing environment.

In many instances the decision would likely be to delay the purchase which would trigger the need of updating the lease recorded in the books based on the new timing and payments (delayed purchase could mean different price and would surely imply a later lease termination date).

Remeasurement of Leases

Governing procedures specify that after the commencement date, changes to the lease payments (triggered by changes in the lease term or certainty in exercising a purchase option) would cause the remeasurement of the lease liability which would be recognized as an adjustment to the right of use asset. The update that needs to take place in the financial statements of the lessees requires to remeasure the lease.

Remeasurement Guidance

On the date when the lessee is in the situation defined above, the remeasurement would take place following the steps summarized below.

First, the contract is reassessed in order to look at the remaining components which would be classified as lease and non-lease. The lease liability is remeasured in light of the revised lease payments and the discount rate is updated based on the date of the remeasurement.

Then, in line with the lease liability amount adjusted, the right of use of the asset is updated. In case of a liability reduction, the right of use asset is also reduced but cannot be below zero and any excess would impact the income statement. Once updated, the amortization of the asset is also updated to reflect the amortization pattern of the right-of-use asset.

The next steps is to reassess the lease classification (for lessees: finance vs. operating) which should be done based on circumstances as of the date of reassessment. For instance, in the current context, the asset could have significantly changed its fair value, which could change the equation when comparing it to the sum of the lease payments, a factor that delineates lease classification. Another key variable that could impact how it is catalogued is the remaining economic life of the underlying asset on the remeasurement date in comparison with the new lease term.

In case the lease classification is changed due to the reassessment, the lessee will register a change in the configuration on how to record and present its financial statements.

Closing Remarks

In light of the context outlined, management of companies are likely evaluating all possible paths and responses to cash flow constrains. A clear option to be analyzed is to leverage the current lease contracts and to reconsider the planned cash out purchase options which, in turn, can free up resources. This alternative can specially be reasonable for contracts tied to a variable index in the current low interest rate environment. At the same time, this route would imply the described remeasurement process and would entail changes in the Financials of the company.

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