Lease Accounting Guidance

Background

With the adoption of ASC Topic 842: *Leases* (Topic 842) quickly on the horizon for entities reporting under US GAAP, certain accounting and reporting changes will also become effective for hotels reporting in accordance with the *Uniform System of Accounts* (USALI), Eleventh Revised Edition. This change will impact all entities that are lessees, and to a lesser extent, those that are lessors. Common examples of leases in-place at hotels include ground leases, vehicles/shuttle buses, golf carts, kitchen equipment, network equipment, computers and copiers. In addition, many hotels are lessors of retail and office space.

Summary of Change

Where the hotel or owner is the lessee, hotel ownership must classify leases as either operating or finance leases. For both types of leases, lessees will be required to record a right-of-use (ROU) asset and an offsetting lease liability. The subsequent accounting, however, for these assets and liabilities will differ based upon lease classification, as summarized as follows:

- Operating leases - A single lease cost will be recognized based upon a straight-line total lease cost, which consist of the amortization of the ROU asset and adjustment to the lease liability for the present value of the remaining lease payments.
- Finance leases – Two separate expense components will be recognized: amortization and interest. Amortization of the ROU asset, typically on a straight-line basis, will be recognized. Interest expense will be recorded on the lease liability. The impact of the separate components noted will result in a front-loading of costs over the term of the lease.

Operating Leases

The ROU asset and offsetting lease liability must be recorded on the balance sheet of the hotel. The ROU asset should be presented within other assets (noncurrent) and the lease obligation should be presented within current liabilities and other long-term liabilities.

USALI, Eleventh Revised Edition, provides proscriptive guidance as to where the rental costs are to be presented in Summary Operating Statements and their supporting schedules. Depending upon the nature and purpose of the individual lease, rental costs may be presented as a departmental expense (e.g. short term rentals may be recorded as Equipment Rental, Guest Transportation, Rent, Employee Benefits, etc.) while long term rentals are recorded in Non-Operating Income and Expenses in Rent.

Following the adoption of this change, the “single lease cost” for operating leases are expected to be presented consistent with rental costs under existing USALI.

Finance Leases

Under USALI, Eleventh Revised Edition, lease payments for property and equipment financed under a capital lease per existing US GAAP definitions would not be treated as rental costs, but “instead should be treated as required according to GAAP.”

Although many management agreements require approval of all leases with owners, understanding the delineation of responsibilities for lease accounting between the hotel manager and hotel owner is of paramount importance to ensure that all leases are being appropriately considered.

Should a question arise related to financial statement presentation, the principles of US GAAP prevail.

Effective Date

This change will be effective for USALI reporting purposes effective January 1, 2020, though earlier adoption as of January 1, 2019 is strongly encouraged. Entities for which the owner follows another basis of accounting (e.g. US GAAP, IFRS), should follow required effective dates.

Lease examples

Van rental – operating lease

Structure. Property A contracts with Dealership B to lease a van to transport guests to and from a nearby airport. The following facts are relevant at the lease commencement date:

- Non-cancelable term of lease – 5 years
- Lease payments – fixed payments of $6,000 per year
- Fair value of van - $50,000
- Transfer of ownership – no
- Renewal/purchase options – none
- Economic life of van – 10 years
- Property A's incremental borrowing rate – 4.5%
- Present value of the lease payments - $26,340

Evaluation. Property A classifies the lease as an **operating lease** based upon the following:

- Transfer of ownership test – No
- Lessee purchase option test – No
- Lease term test – No
- Present value test – No (53%, or $26,340/$50,000)
- Alternative use test – No

Subsequent accounting. Following the initial measurement of a right to use asset and lease obligation of $26,340, Property A subsequently accounts for the **operating lease** as follows:

Year	Lease Liability Beginning Balance	Interest	Pymt	Ending Balance
1	$ 26,340	$ 1,185	$ (6,000)	$ 21,525
2	21,525	969	(6,000)	16,494
3	16,494	742	(6,000)	11,236
4	11,236	506	(6,000)	5,742
5	5,742	258	(6,000)	0

Year	ROU Asset Amortization SL Rent Cost	Lease Liability Accretion	ROU Asset Amortization	ROU Asset Carrying Amount Beg. Balance	ROU Asset Amortization	End. Balance
1	$ 6,000	$ (1,185)	$ 4,815	$ 26,340	$ (4,815)	$ 21,525
2	6,000	(969)	5,031	21,525	(5,031)	16,494
3	6,000	(742)	5,258	16,494	(5,258)	11,236
4	6,000	(506)	5,494	11,236	(5,494)	5,742
5	6,000	(258)	5,742	5,742	(5,742)	0

Kitchen equipment rental – finance lease

Structure. Property A contracts with Manufacturer B to lease kitchen equipment. The following facts are relevant at the lease commencement date:

- Non-cancelable term of lease – 8 years
- Lease payments – fixed payments of $5,000 per year
- Fair value of equipment - $40,000
- Transfer of ownership – no
- Renewal/purchase options – $1 purchase option after 8 years
- Economic life of equipment – 10 years
- Property A's incremental borrowing rate – 5.0%
- Present value of the lease payments - $32,316

Evaluation. Property A classifies the lease as a **finance lease** based upon the following:

- Transfer of ownership test – No
- Lessee purchase option test – Yes ($1 purchase option is deemed "reasonable certain" to exercise)
- Lease term test – Yes (80%, or 8/10 years is greater than the 75% "bright-line" threshold)
- Present value test – No (81%, or $32,316/$40,000)
- Alternative use test – No

Subsequent accounting. Following the initial measurement of a right to use asset and lease obligation of $32,316, Property A subsequently accounts for the **finance lease** as follows:

	Lease Liability				ROU Asset Carrying Amount		
Year	Beginning Balance	Interest	Pymt	Ending Balance	Beg. Balance	ROU Asset Amortization	End. Balance
1	$ 32,316	$ 1,616	$ (5,000)	$ 28,932	$ 32,316	$ (4,040)	$ 28,277
2	28,932	1,447	(5,000)	25,378	28,277	$ (4,040)	24,237
3	25,378	1,269	(5,000)	21,647	24,237	$ (4,040)	20,198
4	21,647	1,082	(5,000)	17,730	20,198	$ (4,040)	16,158
5	17,730	886	(5,000)	13,616	16,158	$ (4,040)	12,119
6	13,616	681	(5,000)	9,297	12,119	$ (4,040)	8,079
7	9,297	465	(5,000)	4,762	8,079	$ (4,040)	4,040
8	4,762	238	(5,000)	(0)	4,040	$ (4,040)	-