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Current Issues and Considerations in Accounting for Leases

Principles and Practices Board
Issue Analysis

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About P&P Board Issue Analyses

The Healthcare Financial Management Association, through its Principles and Practices (P&P) Board, publishes issue analyses to provide short-term practical assistance on emerging issues in healthcare financial management. Issue analyses are factual, but nonauthoritative. To expedite information to the industry, issue analyses are not sent out for public comment. The purpose of this issue analysis is to provide some clarity to the healthcare industry on certain accounting and reporting issues resulting from FASB Accounting Standards Update (ASU) 2016-02, *Leases* (Topic 842) and GASB Statement No. 87, *Leases*, to increase transparency and comparability of lease transactions. Implementation efforts are expected to be significant, especially for lessees. Some entities are already working through implementation plans. As these healthcare entities implement the new standards and apply them to their arrangements, certain issues have been raised that require clarification in the transition to the new standard. This issue analysis highlights the current issues and considerations in accounting for leases. Additional interpretive guidance may be released as circumstances evolve. Consultation on these matters with independent auditors is highly recommended

Overview

When the Financial Accounting Standards Board (FASB) issued its new lease accounting standard in early 2016, the clock started ticking on a sweeping set of changes that private sector healthcare organizations would have to implement. With the release of a similar standard by the Governmental Accounting Standards Board (GASB) in June 2017 (GASB Statement No. 87, *Leases*), governmental healthcare organizations are also swept up in the need to prepare. These changes will not be limited to the accounting department; the new rules will impact any department that deals with leases — including procurement and corporate real estate — and virtually all systems and processes that entities use in managing their lease data.

The effective dates have been modified since the initial issuance. The amendments in ASU 2020-05, *Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842)*, affect entities in the "all other" category (those that are not are not public business entities, certain nonprofit entities, and certain employee benefit plans), as well as public nonprofit entities that have not yet issued financial statements reflecting adoption of the new lease accounting standards. Private entities in the "all other" category may defer to fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Nonprofit entities that have issued or are conduit bond obligors for securities that are traded, listed or quoted on an exchange or an over-the counter market that have not yet issued financial statements or made financial statements available for issuance may defer to fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early application continues to be permitted.

Leasing is widely used to secure access to assets in healthcare. Up-front acquisition costs for new technologies are often prohibitive, given most hospital and physician practices' slim operating budgets and cash flow constraints. Leasing enables healthcare organizations to use property and equipment without making large initial cash outlays. It also provides flexibility, enabling lessees to address obsolescence in rapidly changing technologies. Due to the magnitude of lease transactions in the industry, and the likelihood that leasing will continue to be used as a strategic deployment of capital in the future, healthcare organizations should start planning now for the wide-reaching impacts expected across organizations as a result of the new changes.

Summary of FASB changes. Disclosure requirements have significantly increased for both lessees and lessors. Additionally, the following changes apply to lessees:

- *Virtually all leases must be reflected on the balance sheet.* Arguably the most significant impact of the new guidance for most entities is that lessees are required to report both operating and financing leases with a term of more than one year, by reflecting both a lease liability and "right to use" asset on the statement of financial position.
- *A dual classification model is retained for the income statement.* Recognition of lease-related expense in a lessee's income statement will depend on the lease's classification as either an operating or financing (capital) lease. Leases classified as operating leases under future generally accepted accounting principles (GAAP) will have a straight-line expense recognition pattern while leases classified as financing will have a front-loaded expense recognition pattern similar to today's capital leases. Although the pattern of expense recognition may be similar to today's accounting, the amount of lease expense recorded could differ significantly due to changes in how certain elements of rent payments are treated.

For lessors, the accounting model is fundamentally equivalent to existing guidance, but lessors will need to consider the timing implications of the new revenue recognition standard. The changes must be adopted in financial statements for fiscal years beginning after December 15, 2018 (e.g., CY19 or FY20) for public companies and not-for-profit healthcare entities with conduit bonds, with all other entities (i.e., private companies and other not-for-profit entities) adopting two years later.

FASB has offered two methods to recognize and report leases. The simpler method does not include adjusting comparative periods. In this method, the entity applies the guidance to each lease that had commenced as of the beginning of the reporting period. This is referred to as the "application date" or the "effective date" under this method. Cumulative effect adjustments should be reported as of that date.

The second method includes adjusting comparative periods. Entities will have to apply the new rules to leases existing at the beginning of the earliest comparative period presented. For example, say that a calendar-year-end not-for-profit conduit bond obligor adopts the new standard on January 1, 2019. If the 2018 financial statements are presented for comparative purposes, the new rules must be applied as of January 1, 2018. This means that lessees must recognize lease assets and liabilities on the balance sheet for all leases, and must provide the new and enhanced disclosures, for each period presented (including the prior comparative period).

Summary of GASB changes. GASB Statement No. 87, *Leases*, issued June 28, 2017, *establishes a single model* for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. A lease is defined as a contract that conveys control of the right to use another entity's nonfinancial asset (the underlying asset) as specified in the contract for a period of time in an exchange or exchange-like transaction. The lease term is defined as the period during which a lessee has a noncancelable right to use an underlying asset, plus the following periods, if applicable.

Considerations for lessees include the following:

- *Virtually all leases must be reflected on the statement of net position*. A lessee should recognize a lease liability and a lease asset at the commencement of the lease term, unless the lease is a short-term lease (i.e., less than 12 months at commencement of the lease) or unless the lease transfers ownership of the underlying asset.
- *A lessee should reduce the lease liability as payments are made and recognize an outflow of resources (for example, expense) for interest on the liability.* The lessee should amortize the lease asset in a systematic and rational manner over the shorter of the lease term or the useful life of the underlying asset. (See alternative option for expense recognition below.)
- *The notes to financial statements should include certain information.* A description of leasing arrangements, the amount of lease assets recognized and a schedule of future lease payments to be made should be included.

The following considerations apply to lessors:

- *A lessor should recognize a lease receivable and a deferred inflow of resources at the commencement of the lease term.* There are certain exceptions for leases of assets held as investments, certain regulated leases, short-term leases and leases that transfer ownership of the underlying asset. A lessor should not derecognize the asset underlying the lease.

- *Revenue must be recognized systematically.* A lessor should recognize interest revenue on the lease receivable and an inflow of resources (for example, revenue) from the deferred inflows of resources in a systematic and rational manner over the term of the lease.
- *The notes to financial statements should include certain information.* The notes should include a description of leasing arrangements and the total amount of inflows of resources recognized from leases.

The requirements of GASB Statement No. 87 are effective for reporting periods beginning after December 15, 2019. Earlier application is encouraged.

Healthcare industry organizations report under both FASB and GASB standards. GASB recognized that expense recognition for government and nongovernment providers would be different based on the separate lease standards adopted by FASB and GASB. As noted in the Basis for Conclusion of GASB Statement No. 87 (Item B56):

> *"(T)he Board concluded that amortization of the lease asset should be calculated in a systematic and rational manner to be consistent with depreciation and amortization of other capital assets. Amortization in a systematic and rational manner does not necessarily mean the same amount would be amortized in each period. For example, a calculation that results in a constant total lease cost (the total of the separately determined interest and amortization) could be considered systematic and rational in some cases."*

This statement appears to allow government providers reporting under GASB standards some flexibility in determining how to recognize total lease cost. Providers should carefully consider which option they choose as the timing of expense recognition may impact various reimbursement programs and ultimately impact results from operations and related cash flow.

What constitutes a lease?

Lease accounting guidance applies to any arrangement that conveys control over an identified asset to another party in exchange for consideration. An arrangement is a lease, or contains a lease, if an underlying long-lived *physical asset* used in the entity's operations (i.e., a capital asset) is explicitly or implicitly identified and the customer controls use of the asset. It is particularly important to understand which arrangements contain leases. Many service contracts, including those for reagents and consumables for medical devices, or research equipment, may contain a lease for accounting purposes, although in legal form they do not appear to be a lease. Under the new guidance, balance sheet amounts will be misstated if embedded leases, such as those, are not identified and accounted for as such. This highlights the importance of communication and guidelines for those working in financial and operational areas of healthcare organizations.

Developing a roadmap to implementation: Insights from the field

Adopting the lease standards may be a significant undertaking for healthcare organizations. The new guidance will likely require modifying or developing new lease systems, processes and related controls. Early in the transition process, entities will need to focus on certain key decisions that will influence the nature of the work to be performed. For example, FASB entities will need to decide whether to early adopt and whether to elect the relief package available at transition. Some may be ambivalent about whether to reconsider scope if they believe some arrangements may no longer be leases, factoring in the cost of reclassifying their leases and reconsidering capitalized initial direct costs. FASB lessors should consider the benefits of analyzing contracts just once for leasing and revenue; however, transition differences and the work involved to adopt both standards at the same time would also need to be considered.

In preparing for adoption, organizations will need to develop a plan to implement the new requirements. Many organizations currently undertaking their assessments are finding that the most daunting challenges the new leasing standards will pose are only tangentially related to accounting. Challenges may be divided into four main areas: data, systems, processes and people. Focusing on the four areas will better enable management to have a measured implementation process that will not only generate accounting compliance, but also drive long-term strategic operational benefits to the organization.

Challenge 1: Data. Gathering, reorganizing and understanding lease-related data is a key to success. The first step in getting ready for the new standards is to understand and inventory the organization’s lease population. Before making any decisions regarding implementing a new system or attempting to quantify the impact, an entity needs to understand the universe of existing leases and where they reside throughout the organization. Common areas to consider in assessing completeness include creating an inventory of leases, prior year operating lease commitment supporting details, recurring cash disbursements for potential service agreements with embedded leases, procurement and legal and contract management record systems.

Organizations are right to be concerned about their lease data. In addition to the lack of centralized lease information, many entities may have little or no information about small-dollar leases they hold — including leases for office equipment — or about leases held at subsidiaries. Healthcare systems that have grown over the years through acquisitions may find significant differences in the leasing portfolios of the various entities and a disaggregation of the necessary data required to support both the impact to the balance sheet and the enhanced disclosure requirements. Additionally, medical device contracts may contain embedded leases as they provide a piece of equipment for free and the entity either pays per use of the machine or is obligated to purchase a fixed number of consumables and reagents. Inadequate controls over lease data and missing information about who entered into or uploaded a lease agreement in the first place can cause additional problems.

As a consequence, many entities don’t have complete and accurate information about their lease portfolios. Moreover, no single action can easily remedy the situation. Some leases exist in paper form only and have to be digitized; already-digital leases may have to be scrubbed and cleansed. There should be an audit trail that tracks any changes made to leases along the way.

Fortunately, advances in unstructured data analytics are helping entities handle some of these challenges. Notably, improvements in optical character recognition and natural language processing have accelerated and enhanced the conversion of paper documents into consistent, machine-legible formats. In addition, machine-learning technology, by which computers learn from experience in their analysis of large data sets, can make the extraction and organization of key lease terms more efficient. Over time, a system can come to recognize different types of documents, thereby enabling entities to classify leases into different categories. Machine-learning technology can automatically abstract key lease terms to reduce the amount of manual work required to channel critical lease information into a database.

The number and types of data problems that exist will determine how much time an entity should allot for its initial data assessment and data-gathering activities. For many entities, the task represents a big undertaking.

There are also uncertainties about the data collection that will be required for compliance with the new standard. According to a 2017 lease accounting survey of a wide spectrum of U.S. companies, conducted by the commercial real estate services and investment firm CBRE and the consulting network PwC, 39% of organizations surveyed manage their lease agreements and related accounting in a decentralized manner, which means they need to gather information from dozens, perhaps hundreds, of separate sources. Even at entities that have centralized their lease data, the information may be in different kinds of spreadsheets, original paper agreements or scanned PDF files that contain inconsistent characterizations of lease terms and other fields. To put it another way, “centralized” doesn’t necessarily mean “usable.”

Challenge 2: Systems. Organizations will need to determine current state versus future state requirements for their leasing systems. Once the new leasing standards have gone into effect, entities will need sustainable systems to handle their lease administration and accounting. The CBRE/PwC survey found that for more than two-thirds of companies, the default approach has been to manage and account for leases by using spreadsheets. Under the new rules, spreadsheet use will become extremely difficult and time-consuming. With the high number of manual touch points required to track lease activity and maintain the accuracy of lease data within spreadsheet-based leasing inventories, spreadsheets present too high a risk of errors. Entities generally won’t be able to rely on them when lease data moves to the balance sheet.

Most organizations are planning to migrate to software solutions that are built specifically for the purpose, meaning they are designed to perform the lease calculations required by the new standard. Many software companies are developing modules that can handle the new lease accounting rules while offering operational benefits for the end-to-end lease management lifecycle. Implementing the right software can provide financial managers with the confidence they need for compliance and reporting.

For entities that haven’t yet selected a software solution for this purpose, a period of self-assessment is in order. During this period, some organizations (particularly those that rely heavily on spreadsheets, or those with complex operations) may want to consider developing an interim lease management solution that takes advantage of the data integration, visualization and analytics tools currently on the market, many of which may already be in use for other purposes.

Implementing a provisional solution can offer entities the time they need to take a proper inventory of the leasing systems they currently have in place, if any. If they have multiple systems, they should consider consolidating into a single system. An organization with both equipment leases and real estate leases should decide whether it can manage both lease types with a single system. This is also the time to determine major features a next-generation lease accounting system should have—for instance, integration with accounts payable, procurement or the general ledger, and any special reporting or analytics capabilities. As entities decide on those issues, they will effectively be creating the set of core requirements they’ll need in the vendor selection process. Those requirements can also be used in an evaluation of software vendors’ product roadmaps. It is expected that some reporting entities will need an extended period to make the necessary changes to their systems and processes; thus, organizations should be mindful of this time horizon when planning (or accelerating) their adoption and implementation timeline.

Challenge 3: Processes, procedures and controls. Because of the absence of a uniform way of processing leases and the historical lack of dedicated accounting or software systems for maintaining leasing activity, most healthcare organizations haven't followed consistent processes for requisitioning or monitoring leased property or equipment, especially small leases. This is further exacerbated with the decentralization of many procurement departments (i.e., procurement departments in different hospital locations throughout a system or various geographic regions).

With operating leases moving onto the balance sheet, those inconsistencies will have to change as lease balances and lease disclosures will require a different level of scrutiny—not only scrutiny of the tracking of accounting treatment but also of the processes surrounding lease management and lease life cycles.

As a result of increased attention to processes surrounding lease management, organizations will have an opportunity to rethink the ways they handle lease terminations, lease bookings and lease negotiations. The new processes must be documented so they can become standard operating procedures throughout the organization. As with any information that ends up in a company's financial statements that is subject to Securities and Exchange Commission (SEC) Rule 15c2-12, Uniform Guidance regulations or Sarbanes-Oxley rules, strong internal controls must be in place and followed. By considering the following areas within their control framework, entities can implement controls and processes to manage and correct the challenges noted above:

- Property/equipment requisition
- Lease-versus-buy decision framework
- Vendor negotiation and selection
- Contracting and procurement standards (e.g., governmental procurement requirements when federal grant assistance is involved)
- Financial reporting and analytics
- Lease termination/execution/maintenance
- Discount rate
- Right-of-use asset impairment

Challenge 4: People and change. As the magnitude of GAAP change has reached a fever pitch in the last few years for both FASB and GASB entities, organizations will have to react both quickly and strategically in order to best deploy their limited resources. With the new leasing guidance coming on the heels of recently adopted revenue recognition changes, organizations will need to determine what resources, if any, can be redeployed. As discussed, it is likely that many organizations will need to implement new systems, controls and processes in order to comply with the new guidance. These implementation projects take time — in some cases, years.

As such, it's important to start thinking about these resource decisions now. Likely, this will not be one person's full-time job but many peoples' part-time job. Are these resources currently deployed on other GAAP changes? If so, what is the status and estimated completion timeline of that implementation effort? Who owns the implementation? What groups within the organization are potentially impacted? Are these stakeholders aware? Where are these stakeholders located? What will project governance look like? Thinking about these constraints and planning accordingly will be important for a successful implementation.

Items for discussion with auditors

Following are some items for consideration and discussion with auditors.

- *Discounting*. Use the organization's incremental borrowing rate. Nonpublic business entities may elect to use a risk-free rate. Risk free is simpler, but there is a higher balance sheet impact and some potential for leases near the financing lease threshold, as a result of the lease payments versus fair-value calculation, which could trip the threshold.
- *Nonlease components*. Election on an asset-class basis to combine nonlease components with the amount recorded for operating leases is especially useful for embedded contracts so the fair value of the leased asset doesn't need to be determined. (The full value of the fixed payments should be recorded).
- *Synthetic leases*. Operating versus financing lease distinction will still be relevant to most debt covenants and for balance sheet leverage considerations. Synthetic lease arrangements are being developed to avoid significant operating lease liabilities through structured finance contracts.
- *Disclosures*. The new standard will require extensive quantitative and qualitative information.
- *Build-to-suit arrangements*. Developer arrangements for construction of medical office buildings and other building projects will be subject to more principle-based rules, which should be considered.
- *Debt covenants*. Entity-specific agreements should be reviewed to ensure no issues arise from operating lease liabilities. The balance sheet presentation will result in some deterioration of the current ratio as all operating lease assets are long term whereas operating lease liabilities have

The silver lining: A chance to improve the business model

In issuing the new rules, the standard setters focused on filling in a conspicuously empty portion of the balance sheet. Entities should be looking to go beyond meeting the minimum requirements of accounting compliance. The upcoming change may be used as a springboard to improve existing business models.

For instance, some entities may want to more directly involve their procurement departments in their leasing activities, allowing procurement to negotiate lease terms on an enterprise-wide basis. Other entities, having centralized their leasing data, may want to analyze the terms and conditions offered by their lessors—and thus do a better overall job of managing lessors and applying consistency or standards related to acceptable terms by asset. All organizations should seek to reduce or eliminate the cost leakage that results from not taking timely action on leases with terms that are expiring.

Healthcare organizations may also want to standardize their leasing processes by incorporating necessary controls and establishing the circumstances when the lease-versus-buy model gets used. Strong lease-versus-buy models incorporate additional factors into the discounted cash flow analysis that typically pertain to an entity's leasing strategy, such as equipment obsolescence risk. Finally, entities may want to consider performing periodic lease portfolio trend analyses to evaluate both positive- and negative-impact decisions so they can make timely leasing strategy and leasing process improvements.

Making better leasing decisions through portfolio analysis. Portfolio analysis reports can help lessees identify trends in their leasing behavior they may wish to continue, adjust or terminate. A few such reports include:

- *Lessor concentration*. This report shows the concentration of the portfolio by lessor and can drill down into asset type, year, region and other attributes. This type of analysis can highlight potentially excessive concentration among a small group of lessors or show where it makes sense to increase concentration among certain lessors.
- *Rate analysis by lessor*. This report compares rates for similar types of assets among lessors to see if they are comparable. It may identify opportunities for better rate-shopping.
- *Expired leases*. This report shows leases that are past their original or renewal end date and require action. A similar report can show how long leases were held past their original or renewal end dates before action was taken. This type of analysis may reveal particular areas where this type of extended leaseholding is more prevalent than others (e.g., certain types of assets, certain business units, etc.).

Additional Considerations

- Practical expedients offered by FASB are critically important. It is helpful to determine all the practical expedients/elections that need to be made:
  - Package of practical expedients
  - Cumulative-effect adjustment
  - Short-term leases
  - Nonlease components
  - Hindsight
  - Land easements
- Understand that renewal periods should be considered and could significantly increase the liability on the balance sheet.
- Consider using different interest rates based on term, though there are other options to consider.

Getting started

Adjusting to the new lease accounting rules is no small matter, and most organizations are unsure where to begin. Our suggestion would be to assemble a project team consisting of senior accounting staff, the CFO, the controller, the main professionals responsible for real estate and the main technology and system contacts.

An initial meeting can begin by asking about participants' understanding and opinions of the organization's existing lease processes. Such a meeting will likely provide the project team with a sense of how leasing is approached, what relevant policies and procedures are in place and where and how the organization maintains its lease records. After that, the organization can dive more deeply into the structure of the leases it holds and the nature of its lease agreements, paying particular attention to service contracts that have the potential to contain embedded leases. Some entities may have special circumstances that merit attention. For instance, the inclusion of operating lease obligations on the balance sheet could affect entities' debt covenants. Under FASB rules, operating lease obligations are classified as nondebt. Because GASB rules will consider operating lease obligations as capital debt, they are at higher risk for potential covenant violations.

Entities can begin to meet the data, systems and process challenges related to implementing the new lease accounting standard by taking five steps:

1. Form a project team.
2. Develop a baseline understanding of how leases are currently accounted for.
3. Create a plan for assessing the impact and collecting all relevant lease data.
4. Define the core accounting and business requirements needed in a software system for managing and accounting for leases on a go-forward basis.
5. Explore the pros and cons of different software vendors; then move to design and implementation.

In taking these steps, entities will be on the path to accomplishing what they must by the adoption dates.

2019-2020 Principles & Practices Board

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Appendix. Examples: Lessee

Example 1. Financing Lease: FASB and GASB Models

Lessee enters into a three-year lease of equipment and concludes that the agreement is a finance lease because the lease term is for a major part of the remaining economic life of the underlying asset (also three years). The arrangement provides the following:

Lease term	Three years
Annual payments	Year 1 – $10,000
	Year 2 – $12,000
	Year 3 – $14,000
Discount rate	4.235%
Present value (PV) of lease payments	$33,000

Initial	**Year 1**	**Year 2**	**Year 3**
Cash lease payments	$ 10,000	$ 12,000	$ 14,000
Lease-related expense recognized:			
Interest expense	$ 1,398	$ 1,033	$ 569
Amortization expense	11,000	11,000	11,000
Total periodic expense	$ 12,398	$ 12,033	$ 11,569
Balance sheet:			
Right-of-use asset*	$ 33,000	$ 22,000	$ 11,000
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)

**Note: In practice, many entities will likely classify the asset on financing leases as a part of Property, Plant and Equipment (PPE), not a Right-of-use asset.*

Example 2. Financing Lease

	Debit	Credit
At lease commencement		
Right-of-use (ROU) asset*	$ 33,000	
Lease liability		$ 33,000
To initially recognize the lease liability and related ROU asset		
Year 1 journal entries		
Interest expense	$ 1,398	
Lease liability		$ 1,398
To record interest expense and accrete the lease liability using the interest method ($33,000 x 4.235%)		
Amortization expense	$ 11,000	
ROU asset*		$ 11,000
To record amortization expense on the ROU asset ($33,000 ÷ 3 years)		
Lease liability	$ 10,000	
Cash		$ 10,000
To record lease payment		

**Note: In practice, many entities will likely classify the asset on financing leases as a part of Property, Plant and Equipment (PPE), not a Right-of-use asset.*

Example 3. Operating Lease (FASB only) *

Lessee enters into a three-year lease of office space and concludes that the agreement is an operating lease. The arrangement provides the following:

Lease term	Three years
Annual payments	Year 1 – $10,000
	Year 2 – $12,000
	Year 3 – $14,000
Discount rate	4.235%
Present value (PV) of lease payments	$33,000

Initial	**Year 1**	**Year 2**	**Year 3**
Cash lease payments	$ 12,000	$ 12,000	$ 12,000
Income statement			
Periodic lease-related expense			
Interest expense	$ 1,398	$ 1,033	$ 56
Amortization of ROU asset	$ 10,602	$ 10,967	$ 11,944
	$ 12,000	$ 12,000	$ 12,000

Under the FASB model, these amounts can be combined and reported in a single line item titled “lease expense” or “rent expense.”

Balance sheet:			
Lease liability	$ (33,000)	$ (24,398)	$ (13,431)
ROU asset			
Lease liability	$ 33,000	$ 24,398	$ 13,431
Adjust: Accrued rent (cumulative)		(2,000)	(2,000)
ROU asset	$ 33,000	$ 22,398	$ 11,431

* Under the GASB model, all leases are considered financing leases – i.e., a single-model approach.

	Debit	Credit
At lease commencement		
ROU asset	$ 33,000	
Lease liability		$ 33,000
To initially recognize the lease liability and related ROU asset		
Year 1 journal entries		
Lease expense	$ 12,000	
ROU asset		$ 2,000
Balance sheet		$ 10,000
Lease liability	$ 8,602*	
ROU asset		$ 8,602

To record lease expense and adjust the ROU asset to the difference between cash paid and straight-line lease expense (i.e., accrued rent) and adjust the lease liability to the present value of the remaining lease payments with an offset to the ROU asset. For operating leases, a special amortization method is applied to the ROU asset; the amortization amount generally will correspond to the principal reduction of the lease liability.

* The adjustment of $8,602 is calculated as the initially recognized lease liability ($33,000) less the present value of remaining lease payments ($24,398) at the end of Year 1.

Example 4. Comparison

	Financing lease			Operating lease	
	Interest expense	Amortization expense	Total expense	Total expense	Periodic difference
Year 1	$ 1,398	$ 11,000	$ 12,398	$ 12,000	$ 398
Year 2	1,033	11,000	12,033	12,000	33
Year 3	569	11,000	11,569	12,000	(431)
	$ 3,000	$ 33,000	$ 36,000	$ 36,000	$ —

	Lease liability	ROU asset	
	Both lease types*	Finance lease	Operating lease
Initial			
Year 1	$ 33,000	$ 33,000	$ 33,000
Year 2	24,398	22,000	22,398
Year 3	13,431	11,000	11,431

* Financing lease obligations are classified as long-term debt under both the FASB and GASB models. Under the FASB model, operating lease obligations are considered operating liabilities, not debt.