The New Leasing Standards: An Accounting Perspective

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On February 25, 2016, the Federal Accounting Standards Board (FASB) issued Accounting Standards Update No. 2016-02, Leases (Topic 842). The FASB's goal in doing so is to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and to require the disclosure of key information surrounding lease arrangements. In doing so, these new standards will require a more faithful representation of the rights and obligations arising from leases.

The pursuit of faithful representation requires lessees to recognize lease assets and liabilities that arise from leases in the statement of financial position. Moreover, the standards seek disclosure of lease transaction information in regard to lease payments, options to renew, and lease termination. The goal set forth by the new standards is to lessen opportunities for organizations to structure leasing transactions in a manner that achieves a particular accounting outcome. Furthermore, the new standards aim to improve the understanding of lessees' financial commitments while aligning lessor accounting and sales.

The new standards are effective for fiscal years beginning after December 15, 2018 and will affect any organization that enters into a lease or sublease, with some specified exceptions. The FASB defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration." With that in mind, this article will give a broad overview of new concepts within the new FASB standards. More specifically lease classifications, accounting for leases, and the concepts of separating lease and non-lease components.

The most significant change to the accounting standards is how lease assets and lease liabilities have to be recognized by lessees for those leases classified as operating leases under the previous accounting principles. The update maintains two classifications of a lease, finance leases (which replaces capital leases), and operating leases. The lessee should classify a lease as a finance lease if any of the following criteria are met at the time the lease is made: the lease transfers ownership of the underlying asset to the lessee by the end of the lease term; the lease grants the lessee an option to purchase the underlying asset that the lessee is "reasonably certain" to exercise; the lease term is for the major part of the remaining economic life of the underlying asset; the present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset; or the underlying asset is of such specialized nature that there is no expected alternative use to the lessor at the end of the lease term. If none of these criteria are met, it is to be classified as an operating lease.

For a lease classified as a finance lease, a lessee is required to do the following:

1. Recognize a right-of-use asset and a lease liability, initially measures at the present value of the lease payments, in the statement of financial position.

2. Recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income.
3. Classify repayments and the principle portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows.

For an operating lease, a lessee is required to do the following:

1. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position.
2. Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis.
3. Classify all cash payments within operating activities in the statement of cash flows.

Prior to ASC 842, lease classifications were based on a number of criteria ranging from specific bright line rules to numerous interpretations. A lessee often chose operating leases because recognition of the underlying asset and associated lease liability was not required and the rent expense was recognized on a straight line basis over the lease term. While a capital lease mandated the lessee to reflect an asset and corresponding lease liability equal to current value of the future lease payments. However, under the new guidance, almost all leases will require balance sheet recognition as a right-of-use asset and lease liability. Further, the lease classification will affect the amount and timing of the lease and income expense.

It is important to understand that lease contracts may contain non-lease components that should be accounted for using separate accounting models (for example - common area maintenance or services such as security). Only components essential to the right to use the underlying asset are considered lease components. Additionally, updated March of 2017, ASC 842 requires a reporting entity to allocate between the components of the lease arrangement. This type of allocation between components will provide clarity and proper recording of assets and liabilities associated with non-lease components. To be considered a lease component, an activity must transfer a good or service in an arrangement that provides the customer with a right to use the good or service. Yet, an example of an activity related to a lease not subject to ASC 842 guidance would be a supplier who leases a vehicle but also operates the leased vehicle on behalf of the customer. The service (operating the vehicle as a driver for the customer) is not related to securing the truck and thus, not a lease component under ASC 842.

When making this transition to lease reporting, the FASB has provided that lessees and lessors are to use a modified retrospective approach when recognizing and measuring leases and should do so at the earliest period possible. There are a number of practical expedients that entities can elect to use that relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases, and using hindsight to evaluate lessee options to extend or terminate a lease or

when purchasing the underlying asset. Using these expedients will allow an entity to transition smoothly into these new reporting requirements and maintain the proper reporting standards.

If you have any questions or would like to know more about the new lease standards, or have a question about Business Valuation or Succession Planning, call the professionals at The Center at (618) 997-3436.