ACCOUNTING UPDATE

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# New Lease Accounting Standard

**After several years of development, the FASB has issued ASU 2016-02, which supersedes FASB ASC 840.**

## Who Does This Impact?

Entities in nearly every sector of the economy that hold multiple equipment and real estate leases – in particular those with numerous operating leases. The industry sectors we expect to be most impacted include but are not limited to large drugstore chains, telecommunications companies, retail store chains, restaurant chains, airlines, banks and grocery stores.

## When Does This Take Effect?

The new guidance will be effective for public business entities for periods beginning after December 15, 2018 (2019 for calendar year-end entities). For private companies and other entities, the guidance will be effective for periods beginning after December 15, 2019 (2020 for calendar year-end entities).

## What Do I Need to Know?

The main difference between the existing guidance on accounting for leases and the new standard is that operating leases will now be recorded on the balance sheet as assets and liabilities. Under the current standards, only capital (financing) leases are recorded on the balance sheet, and amounts related to operating leases are recorded as rent expenses in the statement of operations and disclosed in the footnotes of the financial statements.

This change in accounting may affect compliance with contractual agreements and loan covenants. For further details about the new standard on accounting for leases, please read more below.

## What Do I Need to Do?

We encourage you to reach out to your auditors and tax advisors to go over the details of how this standard will affect your business.

## Overview and Background

On February 25, 2016, the FASB issued Accounting Standards Update (ASU) 2016-02, *Leases*. The new standard creates Topic 842, Leases, in the FASB *Accounting Standards Codification* (FASB ASC) and supersedes FASB ASC 840, *Leases.* Entities that hold numerous equipment and real estate leases, in particular those with numerous operating leases, will be most affected by the new guidance. Industry sectors expected to be most impacted include large drugstore chains, telecommunications, retail store chains, restaurant chains, airlines, banks, and grocery stores. The amendments in ASU 2016-02 are expected to impact balance sheets at many companies by adding lease-related assets and liabilities. This may affect compliance with contractual agreements and loan covenants.

The main difference between the existing guidance on accounting for leases and the new standard is that operating leases will now be recorded in the statement of financial position as assets and liabilities. Current U.S. generally accepted accounting principles (U.S. GAAP) requires only capital (finance) leases to be recognized in the statement of financial position and amounts related to operating leases largely are reflected in the financial statements as rent expense on the income statement and in disclosures to the financial statements. ASU 2016-02 retains a distinction between finance leases and operating leases. According to the FASB, the classification criteria for distinguishing between finance leases and operating leases are substantially similar to the classification criteria for distinguishing between capital leases and operating leases in existing U.S. GAAP. However, the lease classification criteria in ASU 2016-02 does not depend on bright-line thresholds as they do in existing U.S. GAAP, although ASC 842-10-55-2 indicates that the current bright-line thresholds are "one reasonable approach" to determine lease classification. Also, according to the FASB, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from existing U.S. GAAP.

ASU 2016-02 requires a lessee to recognize the assets and liabilities that arise from leases (operating and finance). However, for leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

## Lessee Accounting

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

- 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
- 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
- Classify all cash payments within operating activities in the statement of cash flows

For finance leases, a lessee is required to do the following:

- 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
- Recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of comprehensive income
- Classify repayments of the principal 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

## Lessor Accounting

The FASB decided to keep lessor accounting essentially unchanged from existing U.S. GAAP. For example, according to the FASB, the vast majority of operating leases should remain classified as operating leases, and lessors should continue to recognize lease income for those leases on a generally straight-line basis over the lease term. Some changes have been made to lessor accounting to conform and align that guidance with the lessee guidance and with the new revenue recognition guidance in FASB ASC 606, *Revenue from Contracts with Customers*.

## Some Key Aspects of the New Lease Standard (ASU 2016-02)

**Definition of a Lease.** Under ASU 2016-02, understanding the definition of a lease and determining whether a contract is or contains a lease will be crucial. Management will need to conduct a thorough inventory of their leasing arrangements. ASU 2016-02 provides detailed guidance and several examples to illustrate the application of the definition of a lease to assist entities in making these determinations. The new guidance on the definition of a lease is much more extensive than current U.S. GAAP.

**Renewal Options.** When measuring assets and liabilities arising from a lease, ASU 2016-02 requires a lessee (and a lessor) to include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is reasonably certain to exercise that purchase option.

**Segregating Lease Components.** Many contracts contain both lease and non-lease (e.g., service) components. Existing U.S. GAAP requires an entity to separate those components but provides limited guidance on how to make those separations. ASU 2016-02 also requires an entity to separate the lease components from the non-lease components but it provides expanded guidance on how entities should account for such contracts. Under existing U.S. GAAP segregating lease components and non-lease components (services) under an operating lease had little financial reporting consequence since operating leases are not capitalized. However, under ASU 2016-02, with operating leases capitalized and services not capitalized, segregated lease and service components will have a significant financial reporting consequence. ASU 2016-02 provides a practical expedient that allows lessees to account for the non-lease components together with the related lease components as a single lease component.

**Sale and Leaseback Transactions.** ASU 2016-02 represents a substantial change from previous U.S. GAAP related to sale and leaseback transactions. For a sale to occur in the context of a sale and leaseback transaction, the transfer of the asset must meet the requirements for a sale in FASB ASC 606. There could be circumstances in which a transaction would have qualified for a sale under the existing leases guidance but will not qualify for a sale under FASB ASC 606, or vice versa. In ASU 2016-02 the FASB notes that many sale and leaseback transactions involving real estate will qualify for sale and leaseback accounting that would not have qualified for sale and leaseback accounting under current U.S. GAAP. However, the FASB also notes that the opposite may be the case for sale and leaseback transactions involving other than real estate.

**Related Party Leases.** In accordance with ASU 2016-02, the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties on the basis of legally enforceable terms and conditions of the arrangement. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties. In addition, lessees and lessors are required to apply the disclosure requirements for related party transactions in FASB ASC 850, *Related Party Disclosures*. In existing U.S. GAAP, entities are required to account for leases with related parties on the basis of the economic substance of the arrangement, which can be difficult when there are no legally enforceable terms and conditions of the arrangement.

**Leases of Specialized Assets.** Although the classification criteria for distinguishing between finance (capital) leases and operating leases under ASU 2016-02 are substantially similar to the criteria in existing U.S. GAAP, ASU 2016-02 adds an additional criterion to consider. A lessee should classify a lease as a finance lease and a lessor should classify a lease as a sales-type lease when the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

## Effective Date and Transition

The amendments in ASU 2016-02 are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for any of the following:

- A public business entity
- A not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission

For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.
Early application of the amendments is permitted for all entities.

In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. An entity that elects to apply the practical expedients will, in effect, continue to account for leases that start before the effective date in accordance with previous U.S. GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous U.S. GAAP.

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