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EXECUTIVE SUMMARY: THE NEW LEASE ACCOUNTING STANDARD[1]

Summary

On February 25, 2016 the Financial Accounting Standard Board (FASB) issued Accounting Standards Update (ASU) 2016-02, Leases. The primary objective of the standard was to improve the accounting for leases, especially the transparency of a company's obligations arising from lease contracts. Under the new standard:

- A lessee is required to recognize all lease contracts – both operating and finance leases – on the balance sheet with the exception of certain short-term leases (less than 12 months).
- Lessor accounting stays mostly consistent with the existing model.
- The standard retains the distinction between finance leases and operating leases, but the required use of bright-line tests that existed under previous GAAP for determining lease classification is eliminated.
- The standard is effective 12/15/2018 for public companies and 11/15/2019 for non-public companies, although early adoption is permitted.

[1] FASB Accounting Standard Update. Leases (Topic 842). No. 2016-02. February 2016.

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Scope

The new standard applies to leases of all property, plant and equipment and excludes 1) leases of intangible assets, 2) leases to explore for or use non-regenerative resources, 3) leases of biological assets, 4) leases of inventory, and 5) leases of assets under construction.

A lessee can also elect not to apply the balance sheet recognition requirement to leases with a term less than or equal to twelve months if there is not an option to purchase the underlying asset that the lessee is certain to exercise.

Identifying a Lease

Under the new standard a lease is defined as: "a contract, or part of a contract, that conveys the right to control the use of identified property, plan or equipment for a period of time in exchange for consideration."[2]

For a contract to meet the definition of a lease, it must meet the following two criteria:

1. The contract must depend on the use of an identified asset or a portion of an asset that is physically distinct.
2. The contract must provide the lessee the right to control the use of the identified asset: the right to obtain the economic benefits from the use of the identified asset and the right to direct the use of the identified asset.

Lessee Accounting Model

Under the new standard, a lessee is required to recognize all lease contracts – both operating and finance leases – on the balance sheet with the exception of certain short-term leases.

At lease commencement, a lessee will recognize on the balance sheet:

- A lease liability: representing the lessee's contractual obligation at the present value of the lease payments not yet paid.
- A Right-of-Use (ROU) asset: representing the lessee's right to use the leased asset over the term of the lease. The initial measurement of the ROU asset would equal the initial lease liability, plus any lease payments made at or before lease commencement, plus and Initial direct costs incurred by the lessee, less any lease incentives received from the lessor.

[2] Ibid, pg. 5.

The subsequent measurement and recognition of the lease will depend on whether the lease is classified as an operating lease or a finance lease. For operating leases, lessees will recognize a straight-line single lease expense over the term of the lease. The ROU asset balance will be adjusted each period by the difference between the lease expense and the theoretical interest amount. For finance leases, lessees will recognize interest expense and amortize the ROU asset in a straight-line basis.

	Income Statement	
	Finance Lease	Operating Lease
Lessee	Interest Expense and Amortization Expense	Total Lease Expense
Lessor	Interest Income	Lease Income

	Statement of Cash Flows	
	Finance Lease	Operating Lease
Lessee	Operating Activities: Interest	Operating Activities: Total Lease Expense
	Financing Activities: Principal Lease Payments	
Lessor	Operating Activities - All Lease Cash Flows	

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Lessor Accounting Model

The new accounting standard didn't change the existing classification used by the lessor for sales-type leases, direct financing leases, and operating leases. The FASB, however, modified how the lessor determines the classification for each lease to align it with changes to the lessee accounting model and the new revenue recognition standard, ASU-2014-09 .

The classification focuses on whether the lease contract transfers control of the underlying asset to the lessee. The lessor will use the same criteria used by the lessee to determine whether control has been transferred.

Lease Classification

Under the new standard, lessees and lessors will use the following criteria to classify leases at lease commencement. The new criteria focuses on whether the contract conveys to the lessee the right of control of the underlying asset. A lease contract is a finance or sales-type leases if any of the following criteria are met:

- 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. (However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.)
- 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.
- 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

[3] FASB Accounting Standard Update. Revenue from Contracts with Customers (Topic 606). No. 2014-09. May 2014
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Transition

The new lease standard requires companies to adopt its provision under a modified retrospective approach. This approach includes a number of optional practical expedients that relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset.

A company that elects to apply the practical expedient will basically continue to account for leases that commenced before the effective date in accordance with previous GAAP, unless the lease is modified. Capital leases will maintain their existing value at transition and a ROU asset and a lease liability will be measured and recognized for all operating leases based on the present value of the remaining minimum payments over the life of the leases as determined under previous GAAP.

Get Ready for Implementation

- Reassess contractual arrangements and use judgment in determining whether contracts that were previously accounted for as service arrangements will be treated as a lease under the new lease standard.
- Determine how debt covenants will be affected and work with lenders to avoid any violations.
- Consider any tax implications.
- Enhance internal controls and accounting processes related to leases.

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Lease Accounting Illustration

A lessee enters into a three-year lease arrangement with no renewal or termination options, and agrees to make the following annual payments:

Year	Amount	Discounted Cash Flow*
1	$ 100,000	$ 94,340
2	$ 150,000	$ 133,499
3	$ 200,000	$ 167,924
Total	$ 450,000	$ 395,763

*Assuming a 6% discount rate per annum

Using a 6% incremental borrowing rate to discount the cash flows, the lessee calculates an initial ROU asset and a lease liability of $395,762. The table below outlines how the lessee would account for the lease depending on whether it is classified by the lessee as an operating lease or a finance lease:

Year	Cash Outflow	Lease Liability	Principal Payment	Operating Lease			Finance Lease		
	Both Methods	Both Methods	Both Methods	Lease Expense*	Adjustment to ROU Asset**	ROU Asset	Interest Expense	Amortization Expense***	ROU Asset
0		$ 395,763				$ 395,763			$ 395,763
1	$ 100,000	319,508	$ 76,255	$ 150,000	$ 126,255	269,508	$ 23,745	$ 131,921	263,842
2	150,000	188,678	130,830	150,000	130,830	138,678	19,170	131,921	131,921
3	200,000	-	188,678	150,000	138,678	-	11,322	131,921	-
Total	$ 450,000		$ 395,763	$ 450,000			$ 54,237	$ 395,763	

* The lease expense equals the sum of the remaining undiscounted lease payments and any initial direct costs, divided by the remaining lease term.

** The adjustment to ROU Asset equals the difference between the lease expense and the interest expense amount

*** The amortization expense equals the initial ROU asset divided by the initial lease term

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The lessee would post the following journal entries throughout the term of the lease:

Operating Lease:		
At lease commencement:		
Dr. ROU Asset	$ 395,763	
Cr. Lease Liability		$ 395,763
Year 1:		
Dr. Lease Expense	150,000	
Dr. Lease Liability	76,255	
Cr. Cash		100,000
Cr. ROU Asset		126,255
Year 2:		
Dr. Lease Expense	150,000	
Dr. Lease Liability	130,830	
Cr. Cash		150,000
Cr. ROU Asset		130,830
Year 3:		
Dr. Lease Expense	150,000	
Dr. Lease Liability	188,678	
Cr. Cash		200,000
Cr. ROU Asset		138,678

Finance Lease:		
At lease commencement:		
Dr. ROU Asset	$ 395,763	
Cr. Lease Liability		$ 395,763
Year 1:		
Dr. Interest Expense	23,745	
Dr. Lease Liability	76,255	
Cr. Cash		100,000
Dr. Amortization Expense	131,921	
Cr. ROU Asset		131,921
Year 2:		
Dr. Interest Expense	19,170	
Dr. Lease Liability	130,830	
Cr. Cash		150,000
Dr. Amortization Expense	131,921	
Cr. ROU Asset		131,921
Year 3:		
Dr. Interest Expense	11,322	
Dr. Lease Liability	188,678	
Cr. Cash		200,000
Dr. Amortization Expense	131,921	
Cr. ROU Asset		131,921

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