Applying the new lease accounting standard

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-02, Leases [codified as Accounting Standards Codification Topic (ASC) 842]. ASC 842 introduces a lessee model that brings most leases onto the balance sheet; aligns certain of the underlying principles of the lessor model with those in ASC 606, the FASB's new revenue recognition standard; and addresses other concerns related to the nearly 40-year-old leasing model from the previous guidance.

Key provisions of the new standard

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ASC 842 is expected to result in the addition of $3 trillion[1] of lease liability (with corresponding recognition of leased assets) to corporate balance sheets. Are you ready?

This document highlights key considerations related to implementing the new leasing standard. See *A Roadmap to Applying the New Leasing Standard* for further details.

Impact on lessee accounting

Lessees are likely to be most significantly affected by the new leasing standard. ASC 842 retains the two-model approach to classifying leases as operating or finance leases (formerly, capital leases); however, most leases, regardless of classification type, are recorded on the balance sheet. A lessee may elect, as an accounting policy, not to record leases with terms of 12 months or less on the balance sheet.

When a lessee records a lease on the balance sheet, it will recognize a lease liability based on the present value of the future lease payments, with an offsetting entry to recognize a right-of-use (ROU) asset. A lessee will use a discount rate to determine the present value on the basis of the rate implicit in the lease, if readily determinable, or the lessee's incremental borrowing rate.

Although both operating and finance leases will be recorded on the balance sheet, the expense recognition pattern will differ for each. For an operating lease, a lessee would recognize lease expense on a straight-line basis over the lease term. For a finance lease, the lessee would recognize both interest expense (by using the effective interest method) and amortization expense. Therefore, the lessee would generally recognize greater expense earlier in the life of the lease for a finance lease than for an operating lease.

Impact on lessor accounting

Although the changes to the lessor model are not as significant as those to the lessee model, lessors should not underestimate the ASU's potential effect on their financial statements and disclosures. Most importantly, the profit recognition requirements under the lessor model are aligned with those under the FASB's new revenue recognition requirements, and the lease classification criteria have been amended to be consistent with those for a lessee. The ASU requires a lessor to classify a lease, at its commencement, as a sales-type lease, direct financing lease, or operating lease on the basis of the classification criteria in the standard.

[1] Yun Li, "A big change in accounting will put $3 trillion in liabilities on corporate balance sheets," CNBC, February 16, 2019, https://www.cnbc.com/2019/02/15/a-big-change-in-accounting-puts-3-trillion-on-corporate-books.html.

Key provisions of the new standard (cont.)

Disclosure requirements

The new standard also significantly expands the lease disclosure requirements. Entities should consider these disclosure requirements early in their implementation efforts to ensure that they are prepared.

Disclosure requirements

Disclosure objectives

Enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases

Lessee disclosures

- Nature of its leases
- Information about leases that have not yet commenced
- Related-party lease transactions
- Accounting policy election regarding short-term leases
- Finance and operating lease costs
- Short-term and variable lease costs
- Gain or loss from sale-and-leaseback
- Maturity analysis for lease obligations
- Weighted-average remaining lease term
- Weighted-average discount rate

Lessor disclosures

- Nature of its leases
- Significant assumptions and judgments used
- Related-party leases transactions
- Tabular disclosure of lease-related income
- Components of the net investment in a lease
- Information on the management of risk associated with residual asset
- Maturity analysis of operating lease payments and lease receivable
- Information required by ASC 360

Definition of a lease

Under the new leasing standard, a contract is, or contains, a lease if the contract gives a customer the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. Control is considered to exist if the customer has both of the following:

1. **The "right to obtain substantially all of the economic benefits from use of [an identified] asset."**
2. **The "right to direct the use of [that] asset."**

Accordingly, the definition of a lease in the new leasing standard differs from that in existing US GAAP. Under legacy accounting guidance, an entity is required to determine whether it has the "right to obtain substantially all of the economic benefits" from the use of an asset. Under the new standard, however, an entity must also determine whether it obtains the "right to direct the use" of the asset.

An entity is required at inception to identify whether a contract is or contains a lease. The entity will reassess its conclusion about whether the contract is or contains a lease only when the terms and conditions of the contract are modified.

Although the assessment of whether a contract is or contains a lease will often be straightforward, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component (an embedded lease) or when both the customer and the supplier make decisions about the use of the underlying asset.

Chapter 3 of the Leasing Roadmap contains a number of helpful examples to illustrate such assessments.

Components of a contract

ASC 842 requires entities to identify the lease and nonlease components of a contract that contains a lease. Although this requirement does not differ from that under existing US GAAP, the effect of not applying this requirement correctly under ASC 842 is more significant because most leases must be recognized on the balance sheet under the new guidance.

A contract or lease agreement may contain multiple lease components. The right to use an underlying asset is considered a separate lease component if both of the following conditions are met:

1. **A lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available.**
2. **The underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement.**

Entities must also evaluate whether the right to use land and other assets should be accounted for separately. Accordingly, a contract may include multiple lease components for different underlying assets.

When a contract includes both lease and nonlease components, an entity may be required to allocate the consideration in the contract to the various elements—for example, a real estate lease in which the lessee pays for both the use of the space (lease component) and common area maintenance services (nonlease component). The consideration allocated to the lease component is accounted for under ASC 842, while the consideration allocated to the nonlease component is accounted for under other relevant GAAP (for example, lessors would recognize revenue earned for common area maintenance services in accordance with revenue guidance).

ASC 842 allows lessees to elect, as an accounting policy, not to separate lease and nonlease components but to account for the entire arrangement as a lease. This election would result in a larger lease liability on lessees' balance sheets.

ASC 842 also allows lessors to elect, as an accounting policy, not to separate lease and nonlease components provided that the nonlease component(s) otherwise would be accounted for under the new revenue guidance in ASC 606 and both of the following conditions are met:

1. **The timing and pattern of transfer for the lease component are the same as those for the nonlease components associated with that lease component.**
2. **The lease component, if accounted for separately, would be classified as an operating lease.**

If these conditions are met, the lessor is required to perform another evaluation to determine whether the combined unit of account is accounted for as a lease under ASC 842 or as a revenue contract under ASC 606. Specifically, an entity should determine whether the nonlease component (or components) associated with the lease component is the predominant component of the combined component. If so, the entity is required to account for the combined component in accordance with ASC 606. Otherwise, the entity must account for the combined component as an operating lease in accordance with ASC 842.

Effective date and transition requirements

The new guidance became effective for public business entities, as well as for certain not-for-profit entities (NFPs) and employee benefit plans, for annual periods beginning after December 15, 2018 (calendar periods beginning on January 1, 2019) and interim periods therein. The effective date for Public NFPs that qualify for the deferral under ASC 842-10-65-1(a), as amended, is annual periods beginning after December 15, 2019 (calendar periods beginning on January 1, 2020), and interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2021 (calendar periods beginning on January 1, 2022), and interim periods thereafter. Early adoption is permitted for all entities.

An entity adopts ASC 842 by using a modified retrospective transition approach. Under this approach, the standard is effectively implemented either (1) as of the earliest period presented and through the comparative periods in the entity's financial statements or (2) as of the effective date of ASC 842, with a cumulative-effect adjustment to equity (the Comparatives Under 840 Option). The modified nature of this transition approach is intended to maximize comparability while reducing the complexity of transition compared with the full retrospective approach, under which financial statements would be prepared as if ASC 842 were always effective.

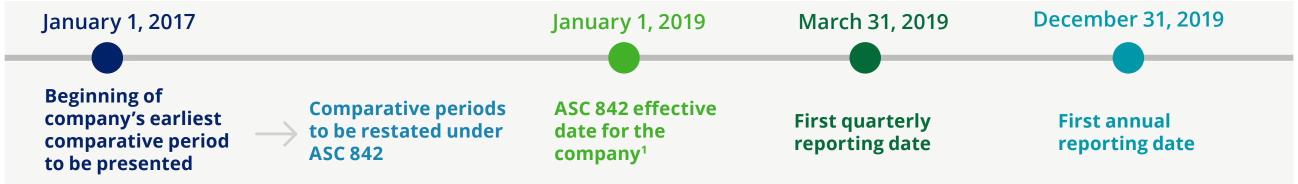
The Comparatives Under 840 Option allows entities to elect not to recast their comparative periods in transition. Accordingly, entities are permitted to change their date of initial application to the beginning of the period of adoption. In doing so, an entity would:

- Apply ASC 840 in the comparative periods
- Provide the disclosures required by ASC 840 for all periods that continue to be presented in accordance with ASC 840
- Recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of the effective date (for example, January 1, 2019, for a calendar-year public business entity)

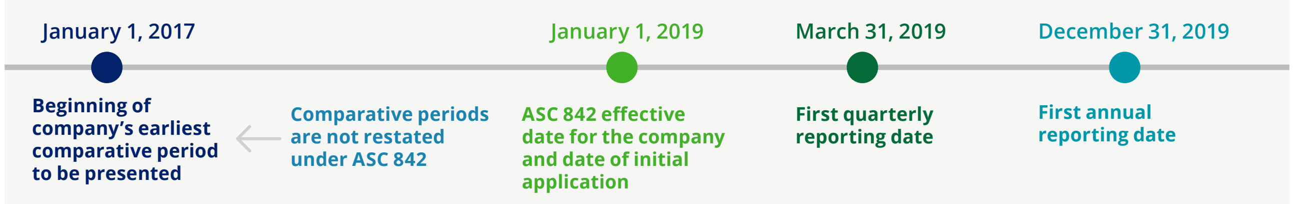
The entity would not:

- Restate comparative periods for the effects of applying ASC 842
- Provide the disclosures required by ASC 842 for the comparative periods
- Change how the transition requirements apply; only when the transition requirements apply

Illustrative timeline for a public business entity with a December 31 year-end that does not elect the Comparatives Under 840 Option



Illustrative timeline for a public business entity with a December 31 year-end that elects the Comparatives Under 840 Option



[1] The effective date for Public NFPs that qualify for the deferral under ASC 842-10-65-1(a), as amended, is annual reporting periods beginning after December 15, 2019 (calendar periods beginning on January 1, 2020), and interim periods therein. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2021 (calendar periods beginning on January 1, 2022), and interim periods thereafter.

Did you know?

Did you know?

The financial statement impact of failing to identify whether a contract is or contains a lease could be much more significant under the new leasing standard. As a result, many companies are "sharpening their pencils" on lease identification.

(See chapter 3 of the Leasing Roadmap.)

Did you know?

Lessees may be required to remeasure the lease liability and ROU asset in certain circumstances. For example, remeasurement is likely to be required when there is a change in circumstances that leads to a change in the previous determination of whether the lessee is reasonably certain it will exercise a renewal option.

(See section 8.5 of the Leasing Roadmap.)

Did you know?

Entities will most likely need to implement new, or change existing, business processes and internal controls to ensure compliance with the new guidance—for example, when applying judgment to aspects of the guidance such as lease term, reassessment events, and allocation of lease payments to lease and nonlease components on the basis of the relative stand-alone selling price.

(See Appendix E of the Leasing Roadmap.)

Did you know?

To comply with all of the new standard's requirements (including those related to disclosures), entities may need to implement new accounting software. Having a better understanding of existing lease contracts, including embedded leases, may help entities decide whether a technology or software solution is necessary.

(See Appendix D of the Leasing Roadmap.)

Did you know?

Contracts with a noncancelable term of less than 12 months might not qualify for the short-term lease exception if an entity is reasonably certain that renewal options will be exercised. Lease term, as defined by ASC 842, includes periods covered by renewal options whose exercise is reasonably certain. The short-term lease exception is available only if the lease term, which includes periods covered by renewal options whose exercise is reasonably certain, is less than 12 months.

(See section 5.2 of the Leasing Roadmap.)

Did you know? (cont.)

Did you know?

Certain third-party residual value guarantees will cause leases to qualify as direct financing leases under ASC 842 when they may have previously qualified as sales-type leases under ASC 840.

(See section 9.2 of the Leasing Roadmap.)

Did you know?

When a lessee determines the discount rate on the basis of its incremental borrowing rate (to measure the present value of the lease liability when the rate implicit in the lease is not readily determinable), the rate should be based on the lessee's collateralized borrowing rate for an instrument with a similar amount and similar term.

(See section 7.2 of the Leasing Roadmap.)

Did you know?

Some "failed" sale-leaseback transactions under legacy GAAP may achieve sale accounting under ASC 842. The requirements related to accounting for a transaction as a sale-leaseback are less cumbersome under the new guidance than under legacy GAAP. Generally, a sale-leaseback will qualify for such treatment if the seller-lessee transferred control of the underlying asset to the buyer-lessor.

(See chapter 10 of the Leasing Roadmap.)

Did you know?

Variable payments based on an index or rate are included in the measurement of a lease liability, which includes payments made on the basis of fair value. Although these types of variable payments are included in the lease liability at initial measurement, the liability would generally not be remeasured as the index or rate changes over the lease term.

(See section 6.3 of the Leasing Roadmap.)

Did you know?

Since the issuance of ASU 2016-02, the FASB has released a number of amendments to ASC 842 to (1) provide a practical expedient that offers entities transition relief related to reassessing land easement arrangements, (2) make certain technical corrections and improvements to the standard, (3) make targeted amendments to lessor accounting and provide transition relief to help decrease the costs of applying the standard's guidance, (4) make certain narrow-scope improvements for lessors, and (5) effective date deferrals for certain entities.

(See chapter 17 of the Leasing Roadmap.)

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