Deloitte.

May 16, 2016

An Executive Summary of the FASB's New Lease Accounting Standard

by Stephen McKinney and Tim Kolber, Deloitte & Touche LLP

Snapshot of the New Standard

On February 25, 2016, after working for almost a decade, the Financial Accounting Standards Board (FASB) issued ASU 2016-02,[1] its new standard on accounting for leases. Under the new standard, a lessee is required to recognize most leases on its balance sheet, which is a significant change from today's accounting requirements. In addition, the new standard aligns certain of the underlying principles of the new lessor model with those in ASU 2014-09,[2] the FASB's new revenue recognition standard (e.g., evaluating how collectability should be considered and determining when profit can be recognized). Furthermore, the new standard eliminates the required use of bright-line tests that exist in U.S. GAAP for determining lease classification.

This new guidance will affect a significant number of entities across all industries because most companies enter into contracts that are or contain leases to support their business operations. The leases standard is effective for public business entities for periods beginning after December 15, 2018 (i.e., calendar 2019). Nonpublic entities will have an additional year to adopt (i.e., periods beginning after December 15, 2019). Early adoption is permitted.[3]

Although the mandatory effective date is a few years away (i.e., January 1, 2019, for calendar companies), the standard's modified retrospective transition approach will require entities to reflect the effect of the new guidance in the earliest year presented in the financial statements. Therefore, in the near term, entities should determine what systems and processes they will need to properly adopt the guidance and should begin developing and designing an implementation plan for their transition to the new standard.

The sections below discuss the new standard's background and scope as well as its definition of a lease, the lessee model, the lessor model, lease classification, and transition requirements.

Background

The FASB and IASB (collectively, the boards) initiated their joint project on leases in 2006. The project's primary objective was to address the off-balance-sheet financing concerns related to lessees' operating leases. However, developing an approach that requires all operating leases to be recorded on the balance sheet proved to be no small task. During the process, the boards had to grapple with questions such as (1) whether an arrangement is a service or a lease, (2) what amounts should be initially recorded on the lessee's balance sheet for the arrangement, (3) how to reflect the effects of leases in the statement of comprehensive income of a lessee (a point on which the boards were unable to converge), and (4) how to apply the resulting accounting in a cost-effective manner.

While the two boards jointly deliberated the new guidance, the boards' respective final standards were not fully converged.

[1] FASB Accounting Standards Update No. 2016-02, *Leases*. The International Accounting Standards Board (IASB), which sets International Financial Reporting Standards (IFRSs), issued its new lease accounting standard, IFRS 16, on January 13, 2016.

[2] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.

[3] IFRS 16 is effective on January 1, 2019. Early application is permitted but only if the entity is also applying IFRS 15, *Revenue From Contracts With Customers*.

Scope

The new standard's scope includes leases of all property, plant, and equipment and excludes (1) leases of intangible assets, (2) leases to explore for or use nonregenerative resources, (3) leases of biological assets, (4) leases of inventory, and (5) leases of assets under construction.

Definition of a Lease

The new standard 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." For a contract to be, or contain, a lease, it must (1) depend on the use of an identified asset (which can be implicitly or explicitly identifiable and takes into account the substantive substitution rights of a lessor) and (2) convey the right to control the use of the asset over the lease term (this depends on a customer's right to obtain substantially all the economic benefits from use of the identified asset while having the right to direct its use).

Lessee Model

At lease commencement, a lessee evaluates the terms of a contract to determine whether the contract is a finance lease or an operating lease. Also at lease commencement, the lessee initially measures the lease by using the right-of-use (ROU) asset approach, which requires all leases other than those that are accounted for under the short-term lease exemption[4] to be recognized on the balance sheet.

At initial recognition of a lease, a lessee measures the liability for its lease obligation at the present value of lease payments not yet paid (excluding variable payments) and a corresponding ROU asset. The initial measurement of the ROU asset would also include (1) initial direct costs (e.g., legal fees, consultant fees, commissions paid) that would not have been incurred had the lease not been executed and (2) lease payments made to the lessor before or at the commencement of the lease. The ROU asset would be reduced for any lease incentives received by the lessee (i.e., consideration received from the lessor would reduce the ROU asset).

Under the FASB's dual-model approach,[5] the subsequent measurement of a lease depends on whether the lease is classified as a finance lease or an operating lease. A finance lease results in a front-loaded expense profile with an interest component while an operating lease generally results in a straight-line expense profile.

Lessor Model

After proposing multiple different amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the current lessor model. The most significant changes align the profit recognition requirements under the lessor model with those under the FASB's new revenue recognition standard and amend the lease classification criteria to be consistent with those for a lessee. Accordingly, the leases standard requires a lessor to use the classification criteria discussed below to classify a lease, at its commencement, as a sales-type lease, a direct financing lease, or an operating lease.

Lease Classification

An entity is required to determine the classification of a lease at lease commencement. The classification criteria under the new standard apply to both lessees and lessors. The evaluation focuses on whether control of the underlying asset is effectively transferred to the lessee (e.g., substantially all of the risks and rewards related to ownership of the underlying asset are transferred to the lessee). Therefore, a lease would be classified as a finance lease (from the standpoint of a lessee) or a sales-type lease (from the standpoint of a lessor) 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."

[4] The new standard gives a lessee an option, as an accounting policy choice, not to apply the recognition requirements to its short-term leases (i.e., leases that have a lease term of 12 months or less and do not include purchase options that a lessee is reasonably certain to exercise). If elected, the option would allow the lessee to recognize the payments on a short-term lease on a straight-line basis over the lease term (i.e., in a manner similar to its recognition of an operating lease today). As a result, such leases would not be reflected on the lessee's balance sheet.

[5] The IASB adopted a single-model approach under which all leases are accounted for in a manner consistent with the accounting for finance leases under the FASB's approach. This is the most significant difference between the FASB's and IASB's model.

- "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."
- "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."

Transition

Lessees and lessors are required to use a modified retrospective transition method for existing leases. Accordingly, they would apply the new accounting model for the earliest year presented in the financial statements. The application of this approach is directly linked to the current lease classification under the current model (i.e., ASC 840) and the lease classification under the new model (i.e., ASC 842). In addition, the final standard contains certain transition relief provisions that may significantly reduce the burden of initially applying the new standard.

Implementation Considerations

The new standard represents a wholesale change to lease accounting. As a result, entities will face significant implementation challenges during the transition period and beyond, such as those related to:

- Applying judgment and making estimates.
- Managing the complexities of data collection, storage, and maintenance.
- Enhancing information technology systems to ensure their ability to perform the calculations necessary for compliance with reporting requirements.
- Refining internal controls and other business processes related to leases.
- Determining whether debt covenants are likely to be affected and, if so, working with lenders to avoid violations.
- Addressing any income tax implications.

These implementation challenges will require entities to develop a robust project plan that involves many steps. For example, entities will need to (1) take inventory of their contracts that are or may contain leases, (2) develop systems and processes to capture the data and information necessary to record and disclose their leases, (3) educate investors and analysts on the impact of the new leases standard on financial statements and various metrics (e.g., debt ratios), and (4) update their accounting policies. Entities will also need to assess internal controls, systems, and data requirements that may be affected as a result of the new guidance.

Find Out More

The following Deloitte publications and resources contain additional information about the FASB's and IASB's new lease standards:

- *Heads Up*, "FASB's New Standard Brings Most Leases Onto the Balance Sheet."
- *IFRS in Focus*, "IASB Issues IFRS 16 — Leases."
- "Operationalizing the new lease standard — Lease accounting" (Deloitte.com).