GETTRYMARCUS ALWAYS LOOKING DEEPER.™

New Lease Accounting Standards

By: Eric Lerner, CPA

On February 25, 2016, Financial Accounting Standards Board (FASB) concluded its decade(s) long leasing project with the release of Financial Accounting Standards Update 2016-02 *Leases (Topic 842)*. The new leasing standard significantly changes lessee accounting compared to existing U.S. GAAP and has some targeted changes for lessor accounting. It also introduces several "accounting elections" to allow practical expedients to exist (i.e., shortcut), of which a few are mentioned herein.

The main feature is that all ***lessees*** will now need to recognize lease assets and lease liabilities for leases that were previously straight operating leases. Furthermore, it alters the entity's financial performance, the presentation of the basic financial statements and complicates simple record keeping and financial statement disclosures.

Key provisions are as follows:

Lessees

Currently, lessees classify their leases as either off balance sheet (operating lease) or on balance sheet (capital lease). Under the new leasing standard, primarily all lessee leases will ***initially*** be treated similar to capital leases and will require (i) the recording of an asset representing its right to use the underlying asset for the lease term "(***right-of-use asset***"), and (ii) a liability to make lease payments ("***lease-liability***").

The ***right-of-use asset*** and ***lease liability*** will originally be recorded by taking the present value of the minimum payments utilizing either the rate implicit in the lease, incremental borrowing rate, or a risk-free rate (a new "***accounting election***" available for privately-held entities). This elective risk free rate will result in recording a larger asset and liability than would otherwise be recorded using the implicit or incremental rates. The new leasing standard does not change the criteria as to when to include or exclude optional periods and variable (contingent) lease payments as minimum payments. For leases with a term of 12 months or less, a lessee will be permitted to make another accounting election not to record an asset and liability and record the lease on a straight line basis. Any accounting election taken must be taken for all leases.

However, there ***still is*** a difference between operating leases and capital leases ***after the initial*** asset and liability is recorded. For a ***finance lease***, the right-of-use asset is amortized on a straight-line basis whereas the payments are applied to interest expense and repayment of the liability. Consequently, greater expense is incurred in the earlier years (due to the interest method) whereas less expense is recorded in the later years. For an ***operating lease,*** the expense to be recorded must be straight-lined but the accounting for it is complex as it involves finance lease accounting and other adjustments each year for each lease. A right to control the underlying asset (not the actual use of) still dominates the straight-line criteria. Tracking operating leases can no longer be done on a simple excel spreadsheet; it will require more effort and sophistication.

Disclosures for Lessees

Lessee disclosure of lease activity within the basic financial statements (after the initial recording of the asset and liability) requires separate line items in the balance sheet for operating and finance lease classifications and cannot be aggregated into one line. In the statements of income and cash flows, finance lease components (interest, amortization, repayments of the principal portion of the lease liability) follow the normal treatment of similar items and need not be separated. As for operating leases, lease expense is to be recorded as an expense in income from operations. Footnote disclosure is ***expanded*** for both quantitative and qualitative information for ***each*** year presented and will also require disclosure of significant judgements made by management.

Lessor

Lessor accounting has remained relatively the same for an operating lease, except for conforming definitions and certain conformity with the new revenue recognition accounting rules particularly in bundled arrangements (minimum lease obligations plus other fixed billing non-lease components). The lease payments are to be recorded in operations over the lease term still on a straight-line basis for fixed and determinable rents. Variable lease payments are to be reflected in operations based on when incurred.

Contract Contains a Lease and Non-Lease Components

Much effort was expended by FASB on determining if a contract contains a lease (i.e., embedded or in-substance lease) and accounting for non-lease components. This will be discussed in one of our future mailings. However, an additional accounting election is available to simplify these but it could result in larger right-of-use assets and lease liabilities.

Other

There are other significant changes to lease transactions (e.g., sale and leasebacks, leveraged leasing – which was virtually eliminated, multiple components for a lessee, multiple components for a lessor (which could result in a different treatment), what is a lease, remeasurements when facts change due to modifications, etc.); those types of transactions will be addressed further on in our series of lease accounting mailings (which this is the first of).

Impact on operations, bank covenants, bonus arrangements, etc.

There could be significant impacts to a variety of obligations, contracts, arrangements, state tax apportionments, deferred taxes, EBITDA and the like once these provisions are adopted and effective. We suggest that for any obligation, contract or arrangement (e.g., incentive programs, long term debt covenants, earn-outs, etc.) that is being entered into, due consideration be given as to how these new leasing provision will impact said agreement. Also pre-existing arrangements will need to be revisited.

Effective Date and Transition Guidance

For private companies, these leasing provisions will take effect for fiscal years beginning after December 15, 2019 and early application is permitted. Adoption will require a modified retrospective approach (as defined).

Eric Lerner
CPA
Director of Quality Control

Contact:
516.364.3390 x 288
elerner@gettrymarcus.com