In brief
The latest news in financial reporting

Lease accounting: The long-awaited FASB standard has arrived

What happened?

On February 25, 2016, the FASB issued its long-awaited revision to lease accounting. There are elements of the new standard that could impact almost all entities to some extent, although lessees will likely see the most significant changes.

The IASB issued its new lease accounting standard on January 13, 2016, with some significant points of divergence from US GAAP. Despite the differences, both Boards noted that their respective standards fulfill the key objectives of lessee recognition of lease-related assets and liabilities on the balance sheet and enhanced transparency.

What are the key provisions?

Lessee accounting model

Lessees will need to recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense (similar to current operating leases) while finance leases will result in a front-loaded expense pattern (similar to current capital leases). Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines.

Lessor accounting model

Lessor accounting is similar to the current model, but updated to align with certain changes to the lessee model (e.g., certain definitions, such as initial direct costs, have been updated) and the new revenue recognition standard. Similar to today, lessors will classify leases as operating, direct financing, or sales-type. Leveraged lease accounting has been eliminated, although grandfathered for existing arrangements.

Embedded leases

An arrangement contains an embedded lease if property, plant, or equipment is explicitly or implicitly identified and its use is controlled by the customer. This differs in certain respects from today’s risks and rewards model and may result in the identification of fewer embedded leases compared to the current guidance.

Lease term, variable lease payment, discount rate, incentives

Lease accounting will continue to require significant judgments, including when making estimates related to the lease term, lease payments, and discount rate. Similar to today, the term of the lease will include the non-cancellable lease term plus renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor.
Variable rent payments are generally excluded, except those based on an index or rate, which are included based on the index or rate at lease commencement. Subsequent changes to the index or rate and other variable payments will be treated similar to contingent rent today. When calculating present value, the applicable discount rate will be determined similar to existing leasing literature, except that lessors will be required to include deferred initial direct costs in their calculation of the rate implicit in the lease. For lessees, lease incentives will be included in the cash flows used to determine the lease liability.

**Reassessment (excluding modifications)**

In certain circumstances, the lessee is required to remeasure the lease payments. Remeasurement of the lease payment may be triggered by a reassessment of the lease term. The lease term is required to be reassessed when, for example, the lessee elects to exercise or not exercise an option contrary to initial expectation. Remeasurement is also required when, for example, the contingency associated with a variable lease payment is subsequently resolved such that the variable lease payment now meets the definition of a lease payment or when there is a change in the amounts probable of being paid by the lessee under a residual value guarantee.

When the lessee remeasures the lease payments, variable lease payments based on a rate or index will need to be remeasured.

Remeasurement of the lease payments requires a remeasurement of the lease liability. When remeasuring the lease liability, the lessee is required to use an updated discount rate, except in specified circumstances. A lessor will not be permitted to reassess its determination of lease term, variable rent, or discount rate.

The remeasurement to the lease liability results in an adjustment to the right-of-use asset until it is reduced to zero, after which any remaining adjustment is recorded in the income statement.

**Sale-leaseback transactions**

Existing sale-leaseback guidance, including guidance applicable to real estate, is replaced with a new model applicable to both lessees and lessors. A sale-leaseback transaction will qualify as a sale only if (1) it meets the sale guidance in the new revenue recognition standard, (2) the leaseback is not a finance lease or a sales-type lease, and (3) a repurchase option, if any, is priced at the asset’s fair value at the time of exercise and the asset is not specialized. If the transaction fails sale treatment, the buyer and seller will reflect it as a financing.

**Disclosures**

Extensive quantitative and qualitative disclosures, including significant judgments made by management, will be required to provide greater insight into the extent of revenue and expense recognized and expected to be recognized from existing contracts.

**Effective date and transition**

The standard is effective for US GAAP public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For private companies (i.e., those not meeting the FASB’s definition of a public business entity), the standard is effective for fiscal years beginning after December 15, 2019 and interim periods beginning the following year. Early adoption is permitted. The new standard must be adopted using a modified retrospective transition, and provides for certain practical expedients. Transition will require application of the new guidance at the beginning of the earliest comparative period presented.
Why is this important?

Since lessees will be required to reflect virtually all leases on their balance sheet, they will need to ensure that they have an appropriate process to gather and report their leases. A first step is ensuring that their inventory of leases is complete and accurate. Leases may be embedded in service arrangements or provided alongside other goods or services. This process may take considerable time and effort, depending on the volume, complexity, availability of existing data and system capabilities, and level of decentralization within an organization. In addition to the impact on transition, the ongoing financial reporting and expanded disclosures under the new standard may require modification to existing systems and processes.

Transition to the new standard will have impacts beyond just financial reporting that should be considered when developing a transition strategy. As a result of changes to the balance sheet, transition may impact debt covenants, apportionment of income for state taxes, and lease versus buy decision making.

What’s next?

We will be discussing the new leasing standard, implications, and implementation issues in our upcoming webcasts:

- Overview of the new leasing rules: Thursday, March 3, 2016, at 1:00 pm EDT
- Creating your implementation strategy: Thursday, March 17, 2016, at 1:00 pm EST

Join the conversation by registering here for one or both webcasts.

Also coming soon...

Bookmark our lease accounting page on CFOdirect as your resource for implementing the new guidance. Over the coming weeks, we’ll add helpful information and insights on the new standard. A glimpse of what’s to come includes:

- Executive level insights through our In the loop series
- An In depth taking a deeper dive into the standard’s overall requirements, along with various industry-focused supplements
- A comprehensive Accounting and reporting guide to help you with your company’s implementation
- Survey: How will the new standards impact you?
- ...and much more.