THE NEW FASB LEASE STANDARD:
WHAT YOU NEED TO KNOW

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LEARNING OBJECTIVES

• Gain an understanding of Financial Accounting Standards Board Accounting Standards Update No. 2016-02 – Leases (Topic 842) and how it differs from prior authoritative guidance

• Recognize how this may impact your organization

• Prepare to implement the new standards within your organization
ASC 840 – CURRENT GAAP

• Current standard (as amended) from 1976
  o Capital Lease vs. Operating Lease
  o Four-part test
    • Conveys ownership at the end
    • Bargain purchase option at the end
    • 75% or more of the economic useful life
    • PV of rents is 90% or more of FMV
ASC 840 – FINANCIAL STATEMENT IMPACT

- Capital Lease
  - Equipment
  - Accum. Depreciation
  - Capital Lease Obligation
  - Depreciation Expense
  - Interest Expense

- Operating Lease
  - Rent Expense
  - No balance sheet effect (unless escalating rent)
ASC 840 – DISCLOSURES

• Capital Lease
  o Equipment Cost
  o Accumulated Depreciation
  o Depreciation Expense
  o Future Minimum Lease Payments (5 Years)
  o Imputed Interest

• Operating Lease
  o Future Minimum Lease Payments (5 Years)
  o Rent Expense
ASC 840 – WHAT WAS WRONG?

- Current standards fell short of presenting a complete picture of an organization’s leasing activities
- Inconsistent application of lease classification
- Operating Leases = Off Balance Sheet Activity
- Users often adjusted financial statements for leasing impact with limited operating disclosures
- Differences with International Accounting Standards
Developed over several years, workshops, meetings with users and preparers of financial statements, and exposure drafts

- FASB issues ASU 2016-2 in February 2016
- New ASC 842 Leases – replaces ASC 840
THE ANSWER (cont.)

• What is not included
  o Intangible assets, biological assets, mineral exploration, inventory, assets under construction

• Issues the FASB had to consider:
  o Lease versus Service
  o Cost to be recorded on day one
  o Cost-effective implementation
ASU 2016-02 – KEY CONSIDERATIONS

- Lease determination
- Lease/non-lease components
- Lease consideration
- Lease classification

- Reporting of leases
- Lease modifications
- Lessor accounting
- Implementation guidance
Prior requirement was determined on whether the agreement transferred right to use for a stated period of time.

Focus was capital vs. operating

Since an asset/liability is created, more focus on determination if a contract contains a lease

Lease = the right to control the use of an identified asset for a period of time (amount of use) in exchange for consideration
ASU 2016-02 – DETERMINE A LEASE (cont.)

• Identifiable asset:
  o Explicitly/Implicitly identified
  o Distinct
  o Substitution rights

• Right to Control the use:
  o The right to substantially all of the economic benefits
  o The right to direct the use of the identified asset

• Reconsider only when terms of the contract change
ASU 2016-02 – LEASE COMPONENTS

• Important to consider since an asset and liability are being recorded

• Identify separate lease components
  o Right of use on its own or with other resources readily available
  o Not interrelated

• A component must transfer a good or service

• Non-lease components – e.g., maintenance

• Allocation of lease consideration
  o Relative to stand-alone prices of each component

• Practical expedient – accounting policy election
ASU 2016-02 – LEASE CONSIDERATION

• Fixed payments
• Variable payments
  o Index linked payments
• Fees paid by the lessee
• Exercise price of options
• Payment of penalties
• Lessees only – amounts probable to be paid for residual guarantees
• Reconsider only if a contract modification
On the lease commencement date, must determine the classification:

- Financing Lease (fka Capital Lease)
  - Transfer of Ownership
  - Option to Purchase
  - Term is for “major part” of the economic life
  - Lease Pmts + Residual Value \( \geq \) the fair value
  - Asset would have no alternative use at lease end
- Operating Lease
ASU 2016-02 – LEASES CLASSIFICATION (cont.)

- Leases less than 12 months are excluded (accounting policy election)
- Eliminates bright-line tests
  - (i.e. BPO, 75%, 90%)
• On the lease commencement date, must determine the **lease term:**
  o Non-cancelable period with right to use, and
  o Optional periods for which it is reasonably certain the option will be exercised

• Reassessment of lease term:
  o Required to reassess if (1) significant change in circumstances, (2) specific term changes, or (3) election to exercise option or terminate which was previously determined to be uncertain
ASU 2016-02 – LEASES CLASSIFICATION (cont.)

• Lease term reassessment example:
  o On June 1, 20X1, ABC Company leased a warehouse for a 10-year term with two 5-year renewal options. On this date, ABC was not reasonably certain that it would exercise the options. The term is 10 years.
  o On June 1, 20X6, ABC installed leasehold improvements with a 10-year useful life. ABC reassessed the warehouse lease and they are now reasonably certain they will exercise the first of two renewal options.
ASU 2016-02 – REPORTING OF LEASES BALANCE SHEET

- Net Present Value of the Lease Liability
  - Discount rate

- Right of use asset
  - Financing
  - Capital
ASU 2016-02 – REPORTING OF LEASES COMPREHENSIVE STATEMENT OF INCOME

• Economics of leases can vary – those economics should be reflected in the financial statements.

• Financing lease
  o Amortization
  o Interest expense

• Operating lease
  o Single cost over the term of the lease (straight-line expense recognition)
ASU 2016-02 – REPORTING OF LEASES CASH FLOW

- Financing lease
  - Operating – interest
  - Financing – liability

- Operating Lease
  - Operations – lease expense
ASU 2016-02 – REPORTING OF LEASES DISCLOSURES

• Qualitative
  o Nature of leases – terms and conditions of variable lease payments, options to extend or terminate, and residual value
  o Future leases not yet commenced
  o Significant assumptions
  o Terms and conditions of sale and lease back transactions
  o Accounting policy elections
ASU 2016-02 – REPORTING OF LEASES DISCLOSURES (cont.)

• Quantitative
  o Lease cost – finance vs. operating
  o Short term lease expense
  o Variable lease expense
  o Sublease income
  o Net gain or loss recognized from sale and leaseback transactions
  o Amounts segregated between finance and operating leases for cash paid, supplemental cash flow, weighted-average remaining lease term, weighted-average discount rate.
  o Maturity analysis (finance and operating separately)
ASU 2016-02 – LEASE MODIFICATION

• Significant changes require a recalculation
• Separate lease or modified lease
• Lease re-measurement
  o What is impacted
• Lease termination
ASU 2016-02 – LESSOR ACCOUNTING

• No significant changes
• Start the discussions now with your clients and prepare for questions and proposed modifications
ASU 2016-02 – IMPLEMENTATION GUIDANCE

• Public (and certain others): fiscal years beginning after December 15, 2018, including interim periods within those years

• Others: Fiscal years beginning after December 15, 2019 and interim periods after December 15, 2020

• Early adoption is permitted for all entities
ASU 2016-02 – IMPLEMENTATION GUIDANCE (cont.)

• Practical expedients – modified retrospective adoption
  o No need to reassess expired or existing contracts
  o No need to reassess existing classifications
  o No need to reassess initial direct costs
ASU 2016-02 – IMPACT

• May affect compliance with contractual agreements & loan covenants

• Most impacted sectors –
  o Drugstore & retail chains, telecommunications, restaurant chains, airlines, banks, grocery stores
ASU 2016-02 – HOW TO GET STARTED

1. Obtain sufficient understanding of leases standard
2. Review current lease portfolio – what types of leases are in your inventory
3. Review current process for leases (what data do you have, what controls do you have, what is missing)
4. Identify actions needed to take to address gaps and estimate financial impact of change
5. Begin to educate stakeholders
6. Talk with your bankers
ASU 2016-02 – HOW TO GET STARTED (cont.)

• You’re making leasing decisions even now, what’s your strategy?
  o Will you renew leases set to expire prior to ASU effective date?
  o How will you structure new leases you execute prior to ASU effective date?

• Your organization will continue to operate, so:
  o How do you keep your lease inventory current as activity happens over the years leading up to the ASU effective date?
  o When will resources be available to address gaps you’ve identified?
QUESTIONS?
THANK YOU FOR YOUR TIME!

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