

# FASB Issues New Lease Guidance

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued its long-awaited standard requiring lessees to recognize all leases with terms greater than 12 months on their balance sheet as lease liabilities with a corresponding right-of-use (ROU) asset. Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*, maintains the dual model for lease accounting, requiring leases to be classified as either operating or finance, with lease classification determined in a manner similar to existing lease guidance.

The ASU's basic principle is that leases of all types convey the right to direct the use and obtain substantially all the economic benefits of an identified asset, meaning they create an asset and liability for lessees. Lessees will classify leases as either finance leases (comparable to current capital leases) or operating leases (comparable to current operating leases). Expenses will be reported on the income statement substantially as they are today—costs for a finance lease will be split between amortization and interest expense, with a single lease expense reported for operating leases.

## Lessee Accounting

Under the ASU, lessees should recognize in their statement of financial position a liability to make lease payments (the lease liability) and an ROU asset representing their right to use the underlying asset for the lease term. Today's capital leases and new leases that are determined to be effectively installment purchases by the lessee will be classified as finance leases, while current operating leases will retain their classification.

Lessees will maintain substantially the same expense recognition patterns for operating leases and finance leases (existing capital leases) as under the existing lease standard. Changes come in terms of the balance sheet and ongoing lease administration.

*To help mitigate debt covenant concerns, FASB decided companies should classify lease liabilities as operating obligations in the financial statements, rather than obligations equivalent to debt.*

A lessee will recognize the value of the asset created by the lease as an ROU asset and a corresponding lease liability for the minimum lease payments, discounted at the rate implicit in the lease (if the rate is not known, the lessee's incremental borrowing rate will be used).

When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is reasonably certain it will exercise an option to extend the lease or will not exercise an option to terminate the lease. Optional payments to purchase the underlying asset should be included in a similar manner. A lessee (and a lessor) will exclude most variable-lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are, in substance, fixed payments.

## Lessor Accounting

Lessor accounting is substantially unchanged. However, the ASU contains some targeted improvements intended to align lessor accounting with the lessee accounting model and with the updated revenue recognition guidance issued in 2014 under Topic 606. Lessors will determine lease classification based on whether the lease is effectively a financing or a sale, rather than an operating lease—the concept underlying existing generally accepted accounting principles (GAAP). Lessors will continue to reflect the underlying asset subject to the lease arrangement on the balance sheet for leases classified as operating; they also will continue to recognize lease income, generally on a straight-line basis over the lease term. For financing arrangements (direct finance or sales-type leases), the balance sheet will reflect a net investment in the lease, representing the sum of the lease receivable and the unguaranteed residual asset. For direct financing leases, the net investment is reduced by any deferred selling profit.

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*The leases standard will have the biggest effect on chain pharmacies, large retailers, financial institutions, airlines, shipping and transportation companies and other enterprises that lease big-ticket items of equipment, as well as on real estate entities. Lessees will need to pay particularly close attention to the separation of lease and nonlease components.*

### Disclosures

The ASU requires both qualitative and specific quantitative disclosures to help investors and other financial statement users better understand the amount, timing and uncertainty of cash flows arising from leasing activities.

### Effective Date

The new guidance is effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, *i.e.*, January 1, 2019, for a calendar-year entity. Nonpublic business entities should apply the new guidance for fiscal years beginning after December 15, 2019, *i.e.*, January 1, 2020, for a calendar-year entity, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities.

### Transition

The ASU allows companies to apply the lease guidance at a portfolio level and elect transition reliefs (termed “practical expedients”); it also provides guidance to help entities meet implementation requirements. Transition reliefs include the ability to:

- Forgo the requirement to review existing contracts for lease arrangements and evaluate lease classification for existing leases
- Forgo the need to identify initial direct costs for leases that commenced before the effective date
- Use hindsight in evaluating lessee options to extend or terminate a lease or purchase the underlying asset

Companies are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. Full retrospective application is not permitted.

The update includes specific transition guidance for sale and leaseback transactions, build-to-suit leases, leveraged leases and amounts previously recognized in accordance with the business combinations guidance for leases.

### Next Steps

BKD will continue to monitor various aspects of the new standard, including FASB’s plans to provide educational information, respond to technical inquiries and stage workshops. Stay tuned for BKD’s white paper on the leases standard, including an analysis of aspects of the standard likely to require judgment and other external auditor and board discussion topics.

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