

## ASC 842 (Leases)

On February 25, 2016 the Financial Accounting Standards Board of the United States (**FASB**) issued substantial new guidance on the treatment of leases for both lessees and lessors. The FASB has followed the issuance of the new lease accounting rules with interpretive guidance, a deferral of the effective date, and tweaks to the initial rules. As the effective date nears, the rate of these pronouncements is expected to decrease. In order to delineate the old rules from the new ones, the FASB decided to embody these rules in a newly created section of the Accounting Standards Codification (**ASC**), so that ASC 840 Leases will be superseded upon implementation of the rules by the new section on leases which is codified in ASC 842 *Leases*.

Due to the relatively short period of time until implementation, entities with leasing arrangements should begin researching the ramifications of the accounting changes immediately.

The effective date of ASC 842, for public companies, is in their first fiscal year beginning after December 15, 2018, which is the year ending December 31, 2019 for calendar year-end entities. All other entities have an additional year to implement and need to start in their first year beginning after December 15, 2019. Due to the relatively short period of time until implementation, entities with leasing arrangements should begin researching the ramifications of the accounting changes immediately.

### Who Will be Affected?

Nearly every entity is involved in leasing transactions, though very few have previously needed to record this activity on their balance sheets. The prevalence of leasing, and the fact that this will be the first substantive change to U.S. lease accounting standards in over 40 years, has led to a great deal of concern as to implementation problems. As this change over date approaches, it is becoming ever-more critical for entities to begin to look at this element of their operations to prepare for the conversion. Beyond the changes required to do the accounting transition, entities should begin to consider the financial statement impact of new leasing arrangements and look for structuring solutions to minimize the impact of such changes in the financial statements.

### What is Changing?

Nearly every entity that is a party to a lease will be impacted by this change.

In lease transactions there are two counterparties to every contract: One is the lessor who has title to the asset being leased and the other is the lessee who gains the right to use the lessor's asset. Under the previous rules, certain leases required the lessee to record the asset on the balance sheet, but most were off balance sheet in nature. The treatment has historically been largely based upon an assessment as to whether the lease was an operating lease (off balance sheet) or a capital lease (recorded as a purchase and a sale).

The most significant element of the change for lessees is the requirement to record leases on their balance sheets going forward. Though there are exemptions for certain leases, most lessees will be required to record an asset related to their right

to use the leased asset as well as a liability for the payments required. The amortization of this right of use and liability would not necessarily be reciprocal to the revenue streams recorded by the lessor.

The changes for lessors will be substantially less significant in scope. The most significant change for lessors is a more specific requirement to separately account for lease elements in a contract from any non-lease elements in that same contract. The contractual elements which represent services would generally need to be separated and accounted for independent from the lease.

Due to the substantial nature of the changes, it makes sense to give a slightly more detailed overview of the changes for both lessors and lessees.

#### Determining if a Lease Contains Service Contracts

These changes in lease accounting standards have brought attention to an area which was previously rarely considered – distinguishing leases from related services. The changes in the lease accounting model and the revenue recognition model require lessors, in particular, to determine if their leases contain service requirements as well. The current standards are quite clear that a lease consists solely of the provision of the asset – anything else, even if it is required for the proper use of the asset, should be accounted for separately.

The determination of the relative costs of service elements which are embedded in leases may be highly judgmental and this must be done to properly allocate the costs. The service element costs should be determined using the best available method and standalone pricing is preferable. If standalone pricing is uncertain, the residual method may be used to estimate price. Lessees may elect to combine a non-lease component into an associated lease component for a class of asset leases, this option is typically not available to lessors.

#### Overview of Lessor Accounting

Lessors are in the fortunate position of having less significant changes to prepare for. Many elements of the previous lease accounting model survive, and lessors will continue to recognize leases at origination as either operating leases, sales-type leases, or direct financing leases. The previously red line tests have been modified to be more judgmental and some of the accounting treatments have been laid out in more detail. The sole area of significant concern is in the accounting for operating leases with services embedded in the lease.

Just about all embedded services would need to be accounted for separately, though there are some minor exceptions. These services would likely be accounted for in accordance with the guidance presented by the FASB in ASC 606 *Revenue from Contracts with Customers*. Based upon the nature of the service agreement, lessors may have a significant change in their revenue recognition pattern as there may be changes for revenues which were previously recorded on a straight line basis.

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As mentioned previously, lessors must assess any new lease at origination to determine if it is an operating lease, sales-type lease, or direct financing leases. Under ASC 842, the tests which underlie the determination of the correct accounting treatment have become slightly more judgmental. The tests are designed to be performed sequentially where the first test determines if the lease is a sales-type lease and the second identifies direct finance leases. Operating leases are identified by their failure to meet the criteria to be classified as some other type of lease.

For a lease to be classified as a sales-type lease, it must meet **any one** of the five following criteria:

- The ownership of the asset transfers to the lessee at the end of the lease;
- The lease includes a purchase option that the lessee is reasonably certain to exercise;
- The term of the lease is for a major portion of the assets remaining economic life (provided that the lease didn't commence near the end of the leased asset's life);
- The present value of the lease payments and residual value guaranteed by the lessee equals or exceeds the asset's fair value; and
- The asset is so specialized in nature that there is no expected alternate use for the lessor at the end of the lease term.

The assessment for a direct finance lease has two criteria and **both** criteria must be met: The present value of the lease payments and residual value guaranteed by the lessee **and** **third parties** equals or exceeds the asset's fair value; and it is probable that the lessor will collect the lease payments as well as amounts to satisfy the residual value guarantee. The initial criteria is almost identical to one of the sales-type lease assessments, with the sole difference being the addition of third party guarantees into the assessment.

Any lease that fails to meet any criteria for classification as a sales-type lease and also fails at least one of the criteria to be accounted for as a direct finance lease is an operating lease. Operating leases are the most common type of lease and the one with lessor accounting with the least complications.

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Lease classification determines the appropriate accounting treatment. The following summaries do not include all of the required details required for proper accounting under ASC 842, but present the broad concepts as to how the accounting would function:

- For sales-type leases, the future lease payments and residual guarantees are discounted to compute the investment in the lease. The investment in the lease is recorded by the lessor as a new asset and the asset being leased is removal from the lessor's books; the difference between these two numbers is accounted for as a gain or loss on the sale. The income stream from such leases includes both the immediate gain/loss on the sale and the stream of interest income from investment in the lease.
- Direct finance lease accounting is quite similar to sales-type leases with a few key exceptions. One big difference is that the profit on sale is recognized over the term of the lease using the effective interest method. Another issue is that the discounting of the lease requires the calculation of two different discount rates, while only one is required for sales-type leases.
- For operating leases, lease revenue is recognized by the lessor on a straight line basis unless some other method better represents the pattern of benefit from the use of the underlying asset. Variable lease elements are recorded as income in the same period that the facts and circumstances on which they are based occur.

### Overview of Lessee Accounting

Changes will be far more drastic for lessees, as nearly all leases will need to be recorded on the balance sheet. There are some exceptions to this general rule, but they are relatively small:

- Lessees may elect to not record short term leases with initial terms under a year in length, provided that this election is disclosed;
- This guidance does not apply to leases of intangible assets, leases covering exploration rights for natural resources, timber leases, or inventory leases; and
- Leases of assets under construction are excluded from this accounting treatment.

Presuming that none of the exemptions apply, an entity will need to start the lease recognition process. This process is broken down into a number of stages where in the company will determine the company will first determine the type of lease and then compute the amounts to record on the balance sheet. Lessees have two types of leases: finance lease or operating lease.



Finance leases are any leases wherein **any one** of the following five criteria are met (these are the same criteria for a lessor's sales-type lease):

- The ownership of the asset transfers to the lessee at the end of the lease;
- The lease includes a purchase option that the lessee is reasonably certain to exercise;
- The term of the lease is for a major portion of the assets remaining economic life (provided that the lease didn't commence near the end of the leased asset's life);

- The present value of the lease payments and residual value guaranteed by the lessee equals or exceeds the asset's fair value; and
- The asset is so specialized in nature that there is no expected alternate use for the lessor at the end of the lease term.

If the lease fails to meet any of these items for classification as a finance lease, the lease would be classified as an operating lease. The majority of leases would be classified as operating leases by the lessee, as was the case under the previous accounting rules.

The impacts of the changes will be different for every company, but there will be some difficulties in implementing this new guidance. The intricacies and required mathematics may be beyond the ability of some entities which lack sufficient accounting resources.

For all leases, the lessee needs to determine and record the lease liability which is the present value of lease payments not yet paid as of lease commencement. The lessee also needs to compute and record the right-of-use asset, which is the sum of the lease liability, initial direct third-party costs incurred by the lessee, and payments made to the lessor before or at lease commencement less any incentives received.

- For finance leases the lessee will need to record interest expense related to the lease liability computed using the effective interest method, amortization expense associated with the right-of-use-asset (which is typically straight-line), and additional variable lease costs for payments not based upon a stated rate or index. All base lease payments are recorded as a reduction of the lease liability.
- For operating leases the lessee will record expense on a straight-line basis. The periodic expense is computed as the total of undiscounted lease payments and initial direct costs divided by the lease term. The lessee must compute the interest expense associated with the lease liability, and record the remainder of the expense as a reduction of the right-of-use asset.

### What Will Be the Impacts from the Changes?

The impacts of the changes will be different for every company, but there will be some difficulties in implementing this new guidance. The intricacies and required mathematics may be beyond the ability of some entities which lack sufficient accounting resources. Similarly, certain entities may not be ready to attempt to determine the proper lease classification or discount rates. Others might not be able to determine appropriate standalone pricing for service elements which are associated with a lease.

ASC 842 will also cause several changes to the balance sheet and the earnings flow. One impact for many lessors will be an increase in net liabilities; these balance sheet changes will impact ratios and may cause problems for debt covenant compliance. Another issue will be changes in the pattern of recording revenues and expenses. Far fewer leases will be recorded straight-line going forward, which will make it more difficult for some users of financial information to understand reported results.

### How Will the Transition Occur?

This accounting transition will need to be accomplished using the modified retrospective approach. In this method, both lessors and lessees will need to retroactively change the financial statements from the earliest period presented to reflect all leases existing during the periods covered by the financial statements. Nothing would need to be done in regards to leases which had expired prior to the periods presented in the financial statements.

There are a number of practical expedients available to ease transition, but the standards do not allow you to pick and choose from the expedients – it is an all or nothing choice. The key expedients are: No need to assess contracts for potential leases not previously recorded, all existing and expired leases would be classified on the same basis as they were previously, and there is no need to assess whether lease origination costs qualify for capitalization under the new standards. By adopting the expedients, there would typically not be any impact to the profit and loss from prior periods, the sole changes would be to the balance sheet. Entities which elect to not adopt the practical expedients may have more far-ranging changes to their financial statements due to lease classification changes or initial cost accounting changes caused by the new rules.

### What Next?

In anticipation of the change in lease accounting it is recommended that companies begin to lay the groundwork for implementation:

- Accumulate relevant information on existing leases.
- Review the transition guidance related to the accounting for leases in force at the implementation date.
- Begin preparing model disclosures including additional information required under ASC 842.
- Determine if additional training or modification to your accounting/ERP systems will be needed to maintain compliance with the new rules.
- Consider the requirements from both a time and staffing requirement required for the first-year financials and determine if you will require outside temporary assistance of any kind.

### How We Can Help

This summary does not cover all the changes required under the new standard, but we are happy to help provide guidance on the changes that will affect your business.

Businesses come to MSPC because of our specialized knowledge of reporting under GAAP and the wide-ranging advice and assistance we can give them.

For more information or to discuss how we could help you with the transition, please contact us.



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