BPM

Accounting Standards Update No. 2016-02, Leases (Topic 842)

03.09.16

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) intended to improve financial reporting about leasing transactions. The ASU affects all companies and other organizations that lease assets such as real estate, airplanes, and manufacturing equipment.

The ASU will require organizations that lease assets - referred to as “lessees” - to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases.

The accounting by organizations that own the assets leased by the lessee - also known as lessor accounting - will remain largely unchanged from current Generally Accepted Accounting Principles (GAAP) (Topic 840 in the Accounting Standards Codification).

How will the ASU Improve Lease Accounting?

- Results in a more faithful representation of a lessee’s rights and obligations arising from leases
- Results in fewer opportunities for organizations to structure leasing transactions to achieve a particular outcome on the balance sheet
- Improves understanding and comparability of lessee’s financial statements
- Aligns lessor accounting and sale & leaseback transactions guidance more closely to comparable revenue guidance in the 2014 revenue recognition standard
- Provides users of financial statements with additional information about lessors’ leasing activities & lessors’ exposures to credit & asset risk as a result of leasing
- Clarifies the definition of a lease to address practice issues within current GAAP and to align concept of control, as used within the definition, more closely with control principle used in revenue recognition & consolidations

What Does the New Guidance Do?

Under the new guidance, a lessee will be required to recognize assets and liabilities for leases with lease terms of more than 12 months.

Consistent with current GAAP, the recognition, measurement, and presentation of expenses and cash flow arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. However, unlike current GAAP - which requires only capital leases to be recognized on the balance sheet - the guidance in the ASU will require both types of leases to be recognized on the balance sheet.

The ASU permits private companies to use risk-free rates when determining the present value of lease liabilities.

The ASU also will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, providing additional information about the amounts recorded in the financial statements.

As previously indicated, the accounting by organizations that own the assets leased by the lessee - also known as lessor accounting - will remain largely unchanged from current GAAP. However, the ASU contains some targeted improvements that are intended to align lessor accounting with the lessee accounting model and with the updated revenue recognitions guidance issued in 2014.

Who Will Be Affected by the New Guidance?

Leasing is an important activity for many organizations - whether a public or private company, or a not-for-profit organization. It is a means of gaining access to assets, obtaining financing, and reducing an organization’s exposure to the risks of full ownership of the underlying asset.

The ASU affects all companies and other organizations that lease assets such as real estate, airplanes, ships, and construction and manufacturing equipment.

When Will the ASU Be Effective?

For public companies, the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Thus, for a calendar year company, it would be effective January 1, 2019.

A public company is any organization that is any one of the following:

1. A public business organization
2. A not-for-profit organization that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
3. An employee benefit plan that files or furnishes financial statements to the SEC.

For all other organizations, the ASU is effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.

Early application is permitted for all organizations.

What about Transition?

The ASU requires reporting organizations to take a modified retrospective transition approach (as opposed to a full retrospective transition approach). The modified retrospective approach includes a number of optional practical expedients - which are describe in the final standard - that organizations may apply.

An organization that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with current GAAP unless the lease is modified. However, lessees are required to recognize on the balance sheet lease assets and lease liabilities for operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under current GAAP.