

Bringing leases into view

With new assets and liabilities coming onto balance sheets, it's time for preparers and practitioners to act.

By Maria L. Murphy, CPA

Accounting for leases, which always has been a complex area, is undergoing significant change with the release of new standards by FASB and the International Accounting Standards Board (IASB).

Although the boards were unable to reach convergence on some key issues, both new standards will lead to substantial changes in presentation as lessees will begin to recognize the assets and liabilities for operating leases on the balance sheet. Practitioners will be faced with new accounting and disclosure requirements, possible changes to systems and internal controls, and new considerations when making business decisions related to leasing transactions overall.

FASB'S BASIC PRINCIPLES

A basic premise of the new guidance is that a lease, by definition, conveys the right to control the use of an identified asset for a period of time in exchange for consideration and therefore creates an asset and a liability for lessees that should be reflected on the balance sheet. For lessors, their accounting model will be similar to what it is today, with certain changes in FASB's standard to conform to the revenue recognition model under ASC Topic 606, *Revenue From Contracts With Customers*, with leases accounted for as either a sales-type, direct financing, or operating lease.

"Today, a lease is present if there is control over specified property, plant, and equipment as defined in ASC [Paragraph] 840-10-15-6, that allows the right to operate, control physical access, or take over substantially all of its output," said Chad Soares, CPA, a PwC national office partner who specializes in leasing. "Tomorrow, you can take all of the output of an identified asset, but if you don't have control, you don't have a lease."

Contractual arrangements must be reviewed to determine whether they contain a "lease." For there

to be an "identified asset," the supplier cannot have the substantive right to substitute the asset used to fulfill the contract, defined as both having the practical ability to substitute and benefiting from exercising the right to substitute. The "right to control" is defined as the right to direct the use of the identified asset *and* to obtain substantially all of the economic benefits from directing the use of the asset. The proposed standards contain specific guidance about control and use that must be evaluated.

If contracts include both lease and nonlease components covering other goods or services, these components are accounted for separately. However, lessees can elect a practical expedient to not separate lease and nonlease components whereby both components are accounted for and recognized as lease components. The consideration in the contract is allocated between those components. This is an area of significant judgment. Lessor income recognition follows different models based on whether it is a lease or nonlease element.

"Bundled full-service leases, including vehicles, rail cars, real estate, and computers, will now need to be bifurcated," said Bill Bosco, CPA (inactive), principal of leasing consulting company Leasing 101 and a member of the FASB/IASB Lease Project Working Group, sponsored by and representing the Equipment Leasing and Finance Association. "In the past, both the operating lease and the service element were off-balance-sheet. Now, the service may be accounted for as an executory contract (off balance sheet), but the operating lease element will be accounted for on the balance sheet as a right-of-use asset and operating lease obligation."

John Hepp, CPA, a partner in the national professional standards group at Grant Thornton, said, "Most in the leasing industry are happy with the new leasing guidance overall. The final changes are not as disruptive as the changes originally

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proposed. ... FASB's lessor model is essentially the same as what they had, which was a risk-and-rewards model that no one was complaining about. There were changes to sales-type leases to conform to the revenue recognition model under ASC Topic 606. Lessees will find that there may be significant changes to how sales are recognized in a sale and leaseback transaction."

FASB has maintained a dual approach for income statement classification for both lessees and lessors. Lease classification will be determined very similarly to existing lease requirements, which call for determining whether a lease transfers substantially all the risks and rewards of ownership to the lessee. The new standard will require lessees to account for most existing capital leases as finance leases, where amortization of the right-of-use asset will be recognized separately from the interest on the lease liability. Most existing operating leases will remain operating leases for income statement recognition under the new FASB guidance, with recognition of a single lease expense generally on a straight-line basis over the remaining lease term. FASB and the IASB use similar models for classification by lessors, but the IASB has a single model for lessees, with all leases accounted for as financings on lessee income statements. Nevertheless, FASB and the IASB agree that leases create right-of-use assets and lease liabilities that should be recognized on the balance sheet (see the sidebar "Measurement: How Assets and Liabilities Are Recognized").

There is an exception to balance sheet recognition for leases with a term of one year or less ("short-term leases"), or one year with a renewal option if the option is not reasonably certain to be exercised. Under U.S. GAAP, lessees can make an accounting policy election to continue to account for these similar to current operating leases and

recognize lease expense straight-line over the lease term. The boards permit lease guidance to be applied at a portfolio level in certain cases, but FASB's guidance is in its basis for conclusions while the IASB's is in its application guidance and provides explicit quantitative exemptions. The IASB also will have an exception for small-value leases.

Under FASB's model, lessors should recognize profit at the start of the lease when the leasing arrangement is effectively a sale of the asset by the lessor. FASB requires that the profit be deferred and recognized over the lease term if the lessee does not obtain control of the leased asset. Under the IASB's model, a manufacturer dealer lessor should recognize profit at the start of the lease, regardless of whether the lessor transfers the underlying asset.

FASB's standard will take effect for public business entities in fiscal years beginning after Dec. 15, 2018, including interim periods within those fiscal years; for all other entities, it will take effect in fiscal years beginning after Dec. 15, 2019, and interim periods within fiscal years beginning after Dec. 15, 2020. Early adoption will be permitted by FASB. The effective date of the IASB's standard is Jan. 1, 2019. Early adoption is permitted by the IASB only if it is concurrent with or after implementation of IFRS 15, *Revenue From Contracts With Customers*.

IMPLEMENTATION TIPS

To fully understand the standards and how to apply them, preparers and practitioners should read the "basis for conclusion" sections of the guidance.

Large global companies reporting under both U.S. GAAP and IFRS will need to adopt new accounting and incremental disclosures under both frameworks (see the sidebar "Disclosures and Transition: New Revelations for Lessees"). Although the effective date will be 2019, now is the time to develop a transition plan.

IN BRIEF

- New standards issued by FASB and the International Accounting Standards Board (IASB) will bring lease assets and liabilities onto lessee balance sheets for the first time for operating leases.
- The boards were unable to reach

- convergence on some key issues, but the standards will lead to substantial changes in presentation for lessees in U.S. GAAP and IFRS financial statements.
- Lessees will encounter new disclosure requirements, may need to change systems and internal controls, and may consider operational changes

as a result of the standard. Lessor accounting will be similar in many respects to previous practices.

- Updating lease inventory and determining the impact on the business model will be among the early tasks preparers may want to perform as they implement the new standard.

To comment on this article or to suggest an idea for another article, contact Ken Tysiac, editorial director, at ktysiac@aicpa.org or 919-402-2112.

Here are eight implementation tips provided by Soares, Bosco, and Hepp that preparers can use to make a smooth transition to the new guidance:

Determine the impact on the business model

Start now to assess existing leases, the way leases are used, and their significance to operations as part of the business model. Accountants should form cross-functional teams with operating departments (real estate, IT, legal, treasury) and discuss with management and boards of directors the potential impact of new accounting rules on future strategic plans and lease-versus-buy decisions.

Update your lease inventory

Update your inventory of lease agreements and review them for specific provisions that will be affected by new lease accounting requirements, including variable rents, service components, renewal and purchase options, residual guarantees, and future rent increases. Identify leases that will still be in effect in the earliest year presented in comparative financial statements in 2019, the implementation year.

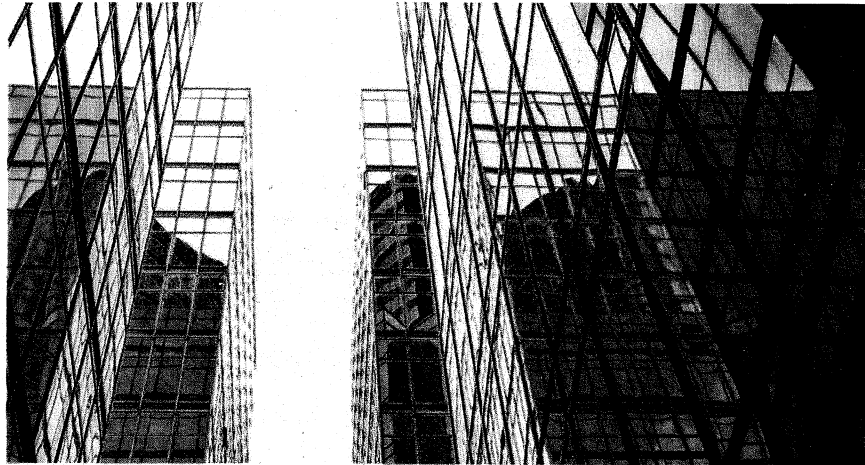
Evaluate the impact of balance sheet changes

Consider any potential impact of changes to the balance sheet on loan covenants and compensation arrangements. The accounting policy for

capitalization of initial direct costs may have to change. Also, evaluate any state and local tax implications as a result of the change in U.S. GAAP.

Consider your software needs

Assess internal controls over lease accounting, since leases are now going on balance sheets. Many companies today are able to use spreadsheets for lease accounting because it is somewhat routine and amounts are generally preset for the life of the leases. Under new guidance, leased assets may need to be accounted for like other fixed assets; there need to be effective controls over initial measurement, subsequent changes, and impairment. New lease accounting software or modified fixed-asset accounting software will likely become available. This area will likely be subject to increased audit and regulatory scrutiny, like most newly adopted accounting standards, and documentation related to controls ▶



Measurement: How assets and liabilities are recognized

As operating leases come onto the balance sheet for the first time, the proper calculation of lease payments will be critical to the amounts of assets and liabilities recognized.

The boards agreed to include all fixed lease payments. Variable lease payments based on changes in rates or indexes (e.g., the consumer price index and Libor (London interbank offered rate)) are included in the initial measurement using the rate or index at the commencement of the lease. Variable payments based on an asset's

use, such as units of production, are not included as lease payments but are recognized as incurred by lessees and as earned by lessors.

However, FASB will require lessees to remeasure the lease payment amount due to changes in the rate or index only if the lease obligation must be remeasured for other reasons (such as a change in the lease contract or term), while other changes in payments are reflected in the income statement as they occur.

The IASB will require remeasurement when the

lease obligation is remeasured for other reasons and whenever a change in the rate or index results in a change in cash flows.

The lease term can affect the amount of lease payments. Similar to existing guidance, the starting point is the noncancelable term of the lease. Renewal options should be included only if the lessee is reasonably certain to exercise the option based on relevant economic factors.

The boards decided that a lessee should reassess the lease term only if there is a significant event or change

in circumstances within its control. If the term changes, the lessee would remeasure the lease liability and adjust the asset using revised inputs at that date. Lessors would not reassess the lease term.

Initial direct costs of entering into leases may be capitalized but are limited to the incremental amounts that would not have been incurred if the lease had not been executed. This guidance excludes internal cost allocations and other costs incurred prior to executing the lease that could be deferred under existing U.S. GAAP.

Disclosures and transition: New revelations for lessees

The new lease standards significantly expand lessee qualitative and quantitative disclosures, although FASB and the IASB differ on specific disclosure requirements.

Both boards intend that disclosures should enable financial statement users to assess the amount, timing, and uncertainty of cash flows from leases. FASB's required lessee disclosures include the nature of the leases, significant judgments and assumptions used to account for the leases, lease expense amounts for finance and operating leases, and maturity tables of lease liabilities. The IASB will require a lessee to disclose sufficient additional information to satisfy the overall disclosure objective. This general requirement is supplemented with a list of specific disclosure objectives and illustrative examples in the standard.

FASB is requiring lessees and lessors to apply a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest period presented in the financial statements. FASB is prohibiting full retrospective transition. The IASB is permitting both modified retrospective transition and full retrospective transition. FASB permits that previous sale and leaseback transactions at the transition date need not be reassessed to determine whether they are a sale. Operating leases will be recorded based on the present value of the remaining minimum rental payments, as disclosed under existing GAAP. Initial direct costs that are no longer capitalizable would be written off to equity.

FASB has included multiple practical expedients that may be elected, but must be elected as a package and applied consistently to all leases. These would allow lessees and lessors not to reassess expired or existing contracts to determine whether they are subject to lease accounting guidance, not to reconsider lease classification at transition, and not to evaluate previously capitalized initial direct costs under the revised requirements. These expedients are only for leases in place at the transition date and cannot be applied to leases that are modified.

and accounting assumptions will be critical. Evaluate the need to invest in new systems and personnel.

Review your lease classification policy

Implement consistent accounting policies and internal controls related to new classification criteria for the entire population of leases. The "bright line" percentage tests for lease classification of ASC Paragraphs 840-10-25-1(c) and (d) ("75% of the economic life" and "90% of the fair value") could be used as guidance in applying principles-based language ("major part" and "substantially all").

Get your rates right

Lessees need to determine their incremental borrowing rates, which will be used when the lessor's implicit rate in the lease is unknown. FASB permits entities that are not public business entities to elect an accounting policy to use the risk-free rate, which is simpler but will likely result in recording a larger asset and liability because of a lower discount rate. The IASB does not provide this election.

Perform credible allocation

Lessees must allocate contract consideration to lease and nonlease components using observable stand-alone prices when available. As a result, lessors may be requested to provide additional "pricing" information to lessees for goods or services provided as part of the lease. This can have both administrative and competitive implications for lessors. Lessees may need to use estimates where such prices are not available, but estimates must be reasonable, consistent, documented, and auditable.

Make an informed decision on transition

FASB transition relief provisions need to be evaluated as a package. Detailed data about the population of leases are needed to make this assessment, which should be done sooner rather than later. The benefit of the transition relief must be compared with the cost to assess whether a "lease" is present for all leases and their classification. ■

AICPA RESOURCES

JofA article

"Checklist: Taking Stock of Leases," Nov. 2013, page 18

Go to journalofaccountancy.com to find past articles.

Audio webcast

"Understanding the New Leases Standard," April 20, 2 p.m. ET (#WC1124531)

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Webpage

Financial Reporting Center, aicpa.org/leases