FASB issues ASU 2016-02 on accounting for leases

Background
On 25 February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. Since 2005, the FASB and IASB have worked together to improve and converge accounting for leases. Russell G. Golden, FASB Chairman, stated that “…the new guidance responds to requests from investors and other financial statement users for a more faithful representation of an organization’s leasing activities. It ends what the U.S. Securities and Exchange Commission and other stakeholders have identified as one of the largest forms of off-balance sheet accounting, while requiring more disclosures related to leasing transactions.”

What’s new?

*Definition of a lease*

The main difference between previous GAAP and ASU 2016-02 is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. ASU 2016-02 defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. Control over the use of the identified asset is evident if the customer has both (1) the right to obtain substantially all of the economic benefits from the use of the asset and (2) the right to direct the use of the asset. Under the lessee accounting model in previous GAAP, the critical determination was whether a lease was a capital lease or an operating lease because lease assets and lease liabilities were recognized only for capital leases. Under ASU 2016-02, the critical determination is whether a contract is or contains a lease because lessees are required to recognize lease assets and lease liabilities for all leases - finance and operating - other than short-term leases.

*Lessee Accounting*

A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. The right-of-use asset is initially measured at the present value of the lease payments over the term of the lease, adjusted for lease prepayments, lease incentives received and the lessee’s initial direct costs. The lease liability is measured at the present value of the lease payments over the term of the lease. A lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and liabilities for leases with a term of 12 months or less. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

The recognition, measurement and presentation of expenses and cash flows for lessees differs between operating and financing classification under ASU 2016-02. For finance leases, the lessees recognizes interest on the lease liability separately from amortization of the right-of-use assets in the statement of comprehensive income. Additionally, repayments of the principal portion of the lease liability are presented in the statement of cash flows within financing activities, and payments of interest on the lease liability are presented within operating activities. For operating leases, lessees recognize a single cost of the lease allocated over the lease term. Additionally, all cash payments are presented within operating activities on the statement of cash flows.
Lessor Accounting

Lessor accounting per ASU 2016-02 is mostly unchanged from the previous lease accounting GAAP. Some changes were made to the lessor accounting guidance in order to align the lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customer. Similar to the previous guidance, lessors will classify leases as operating, direct financing, or sales-type. Lessors in operating leases will continue to recognize the underlying asset and recognize income on a straight-line basis. Lessors determine whether a lease is a sale of the underlying asset based on whether the lessee effectively obtains control of the underlying assets.

Sale and leaseback transactions

Per ASU 2016-02, for a sale to occur in the context of a sale and leaseback transaction, the transfer of the asset must meet the requirements for a sale in Topic 606, Revenue from Contracts with Customers. If control of the identifiable asset passes to the buyer/lessor, then the transaction is accounted for as a sale and a lease by both parties. Conversely, if control of the underlying assets does not transfer to the buyer/lessor, then the transaction is accounted for as a financing by both parties.

Disclosures

The new lease standard requires lessees and lessors to provide disclosures that meet the objective of enabling users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. The expanded disclosures are intended to require enough information to supplement the amounts recorded in the financial statements so that users can understand more about the nature of an entity’s leasing activities.

Effective dates and transition

The ASU is effective for public business entities issuing financial statements for the annual periods beginning after 15 December 2018, and interim periods within those annual periods. For all other entities, the update is effective for financial statements issued for annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. Early adoption of ASU 2016-02 is permitted for all entities.

Per ASU 2016-02, when transitioning to the new standard, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset.

According to the new standard, an entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP.

Our thoughts

ASU 2016-02 will increase transparency and comparability among organizations by requiring the recognition of right-of-use assets and lease liabilities on the balance sheet and disclosing pertinent information about the leasing arrangement. Since ASU 2016-02 will require application of the new standard at the beginning of the earliest comparative period presented, companies should prepare for implementation at least one year prior to the effective date.
About us

MBAF’s Risk Advisory Services practice strives to help manage risks and improve operations within your business. We work with all organizations to help realize business opportunities in complex issues, respond to key market and financial reporting developments and deliver distinctive results.

We serve domestic and international clients across a broad range of industries and practices in more than 44 countries and all 50 states from our offices in New York, Valhalla, Miami, Fort Lauderdale, Boca Raton, Orlando, Baltimore, Boulder, Las Vegas, our overseas office in Ahmedabad, India, and through our independent affiliate network at Baker Tilly International.

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