LEASE STANDARD EFFECTS ON LESSEE

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02 – Leases (Topic 842) which provided a new model for lease accounting aimed to improve transparency and comparability across entities. Although the ASU was issued in 2016, the FASB provided a long implementation period. For entities that are not considered public business entities (PBEs), the standard becomes effective for annual reporting periods beginning after December 15, 2019, which means January 1, 2020 for calendar year-ends.

SO WHAT CHANGED?

Prior to ASU 2016-02, a lessee would record a lease as either an operating lease or a capital lease. An operating lease had no balance sheet impact and rent expense was charged to the income statement as it became payable. A capital lease required a lessee to record a capital lease asset and liability on the balance sheet with the asset being depreciated and the liability being reduced by the lease payments which included interest expense. ASU 2016-02 still has two different classifications of leases, but they are now either an operating or a financing lease. The biggest change however, is that both types of leases will now require the lessee to record a right-of-use asset and a lease liability on the balance sheet. In short, all leases greater than 12 months will have an asset and liability recorded. This will be a significant change in practice for lessees and could have an impact of financial ratios and loan covenants.

Although the changes will not appear in financial statements until December 31, 2020 reporting, the standard does require a modified retrospective transition which means all existing leases as of January 1, 2020 will need to be recorded on the balance sheet on that date (assuming the lessee takes advantage of ASU 2018-11 which allows the new standard to be applied on the date of adoption instead of at the beginning of the earliest period presented). To make sure you are ready for the transition, the most important step to take now is creating an inventory of all leases that will be in existence on January 1, 2020. The following table lists all the relevant information you need to document for each existing lease starting with the date of adoption and going forward into 2020 and beyond.

INFORMATION TO DOCUMENT	CONSIDERATIONS	EXPLANATION
Lease Existence	Control of Asset for Consideration	Because all leases will be recorded on the balance sheet, it is important to identify any contract where a right to control the use of an asset for a period of time in exchange for payment is identified.
	Lease and Nonlease Components	A contract can be a lease in its entirety, or it could contain lease and nonlease components (e.g. maintenance services) which would be accounted for separately. A lessee can make an accounting election to not separate lease and nonlease components and instead account for it as a single lease component (disclosure required if elected).
Lease Term	Noncancelable Period	Period of time stated in the contract where the lease cannot be canceled.
	Optional Periods	If it is reasonably certain a lease will be extended or early terminated via a clause in the contract, those periods would need to be factored into the lease term.
Lease Payments	Fixed Payments	These amounts will not change based on the facts and circumstances of the contract. Many times these are the stated payments per month or year in a lease.
	Plus Variable Payments	These amounts depend on some index or rate like CPI. For example, lease payments could be based on a fixed amount multiplied by CPI.
	Plus Purchase/Term Options	If it is reasonably certain a lessee will exercise a purchase option or incur termination penalties, those amounts would need to be added to the lease payments.
	Plus Residual Value Guarantees	Any probable amount a lessee would owe on a residual value guarantee at the end of a lease should be added to the payments.
	Minus Lessor Incentives	If a lessor provided an incentive to enter into a lease, such as a rent free period, those would reduce the lease payments.
	Equal Lease Payments	The sum of the above components equal total lease payments.

FOR LEASES IN EXISTENCE AS OF ADOPTION DATE OF JANUARY 1, 2020

INFORMATION TO DOCUMENT	CONSIDERATIONS	EXPLANATION
Lease Classification	Practical Expedients	A lessee can elect a package of three practical expedients at transition that allows the lessee to NOT have to reassess the following upon transition: 1) Whether any existing contracts contain a lease, 2) Lease classifications of existing leases, and 3) Initial direct costs for existing leases.
	Operating Lease Before Adoption Date	If the three practical expedients are elected, a lease classified as an operating lease prior to adoption can remain an operating lease without reassessment. A lease liability is to be recorded at the present value of all remaining lease payments and a right-of-use asset is recorded (see next section in table for guidance on value of asset).
	Capital Lease Before Adoption Date	If the three practical expedients are elected, a lease classified as a capital lease prior to adoption will now be a financing lease without reassessment. The lease obligation currently on the books will be retitled to a lease liability with no remeasurement necessary. The capital lease asset on the books (net) will be reclassified to a right-of-use asset (with possible remeasurement).

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FOR LEASES COMMENCING AFTER ADOPTION DATE OF JANUARY 1, 2020

INFORMATION TO DOCUMENT	CONSIDERATIONS	EXPLANATION
Lease Classification	Finance Lease	If one of the following five criteria are met, a lease is a financing lease: 1) Ownership transfers at lease end, 2) Purchase option is reasonably certain to be exercised, 3) Lease term is for the majority of asset's remaining life, 4) Present value of lease payments equals or exceeds substantially all of the asset's fair value, or 5) Specialized asset with no alternative use.
	Operating Lease	If none of the five criteria above are met, a lease is an operating lease. Regardless of lease classification, a lease liability and right-of-use asset will be recorded in the same fashion.
Lease Liability Balance	PV of Lease Payments	The lease liability equals the present value of all lease payments remaining when the lease commences.
	Discount Rate	When calculating the present value above, a lessee should use the rate implicit in the lease if determinable. If not, they should use their incremental borrowing rate. A nonpublic company can make an accounting election to use a risk-free discount rate for all leases.
Right-of-Use Asset Balance	Lease Liability	The lease liability is calculated above and is included in the asset value.
	Plus Lease Payments Already Made	Any payments made prior to the calculation of the lease liability would also be included in the asset value. Also the asset value would be reduced by any lessor incentives received before the lease liability was calculated.
	Plus Initial Direct Costs	Costs directly attributable to obtaining and successfully executing a lease should be added to the value of the asset and deferred.
	Equals Right-of-Use Asset	The sum of the above components equals the value of the asset which is recorded on the balance sheet.

Please note the main differences between operating and finance leases comes in the subsequent accounting which will be covered in a separate article.