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THE NEW LEASE Topic 842

AND WHAT IT MEANS FOR YOU

LEASING

FASB Topic 842 Provides New Standards for Operating Leases

Operating lease information will soon be moving from the footnotes of your financial statements right onto your balance sheets.

In February of 2016, the Financial Accounting Standards Board (FASB) issued an updated lease accounting standard. The new ASU Topic 842 requires that companies and organizations that lease assets such as real estate, airplanes, and equipment include these operating leases on their balance sheet. (Previously, they were only listed under operating expenses.)

The standard was introduced in response to requests from investors and other users of financial statements for more transparent, comparable information about lease obligations and a more faithful representation of an organization's leasing activities and future commitments.

Topic 842 takes effect for public companies in fiscal years beginning after December 15, 2018, and fiscal years beginning after December 15, 2019 for all other organizations.

In this whitepaper, we'll discuss the specifics of Topic 842, those most significantly affected, and what you can do to prepare yourself for implementation.

A Lease Is a Lease… or Is It?

Buildings, copiers, large manufacturing equipment, vehicles… these are just a few of the assets organizations need to continue and grow their operations. However, purchasing these big-ticket items is often not the most cost-effective way to get them. Not only are they expensive to buy, but an entity's progress and level of success will dictate how long these items are needed. Leasing is an easier and more scalable way for them to obtain and use these assets.

However, contract terms can get complex to the point where it's not always easy to see whether it even contains a lease in the first place. The flowchart from FASB included in the following page helps clarify such a situation.

Identifying a Lease

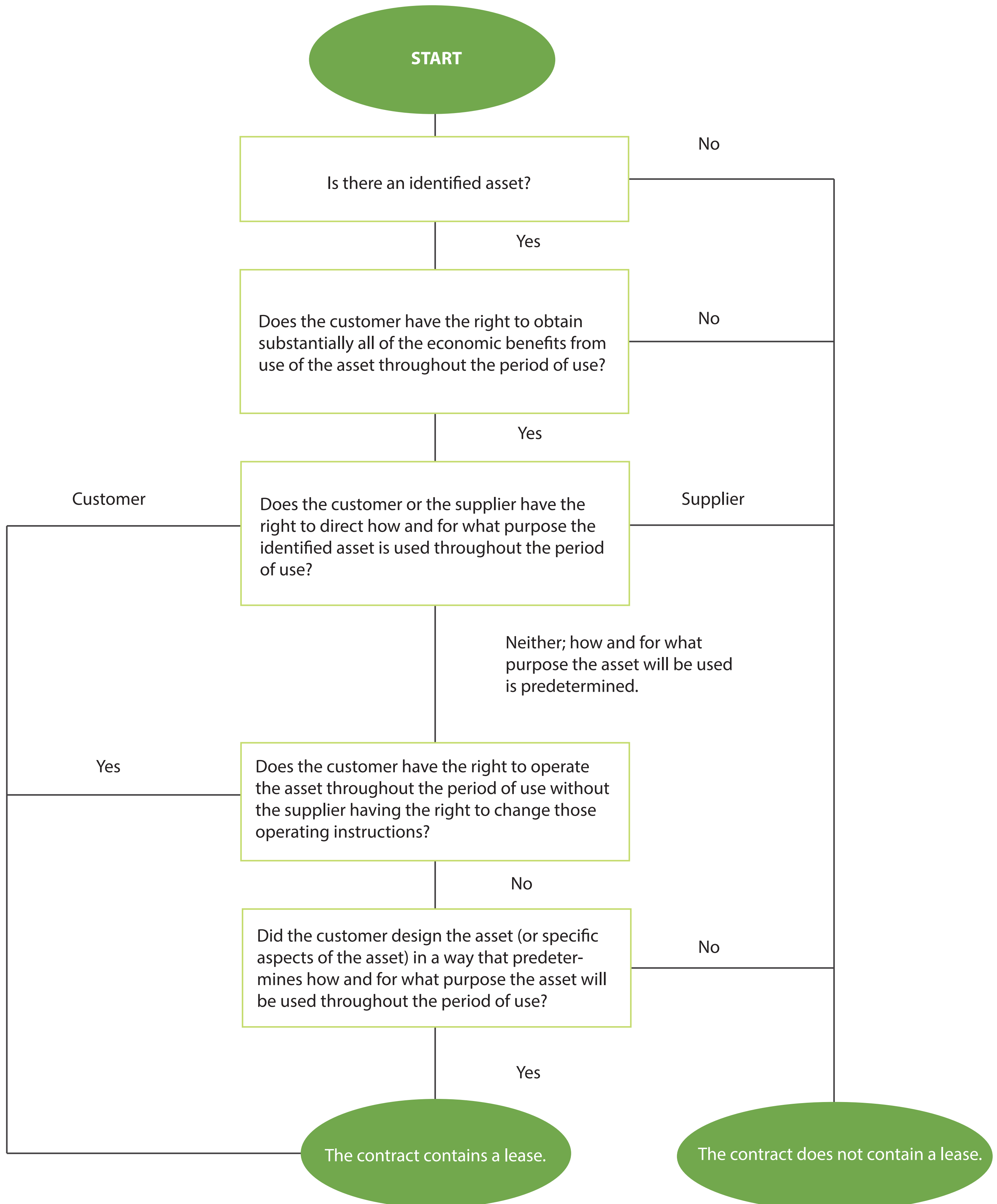

Chart courtesy of the FASB Accounting Standards Update No. 2016-02, Leases (Topc 842)

For the purposes of financial records, leases can be classified as one of two types. An *operating lease* is the more traditional model in which ownership of the asset being leased—and therefore all of the risks and rewards of ownership—remains with the lessor. There is no option to buy the asset and the lessee is generally not responsible for aspects of ownership such as repair or maintenance. Operating lease payments are currently considered an operating expense and the asset is not listed on the lessee's balance sheet.

A *finance lease*, previously known as a capital lease, is set up so that ownership rights (and the risks and rewards) are transferred to the lessee during the term of the contract. It can also provide a purchasing option at the end of the lease term; in essence, it's treated like a loan. Therefore, both the right to use the leased asset and the future lease payments liability are listed on the lessee's balance sheet.

Operating leases are best for an entity that needs more flexibility and does not want or have the resources to handle ultimate responsibility for the leased asset (or if the asset is needed for a shorter term than the expected lifespan of the asset). Finance leases are best for use of assets whose lifespan or economic value will be significantly reduced upon the end of the lease period.

However, the use of operating leases has become much more prevalent in situations in which companies are leasing significant amounts of valuable assets (such as airlines leasing aircraft) with no financial statement representation of the long-term commitment those leases entail. With this new standard requiring both an asset and liability on the balance sheet for all types of leases, some of these operating leases that are more conducive to a finance leasing situation may be renegotiated.

So What Exactly Are the Changes?

The main change, as stated earlier, is ALL leases must now be included in the balance sheet. Operating leases are now accounted for in the same manner as finance leases, with the total future rent payable under liabilities and the value of the right of use for the asset leased listed under assets.

There are also changes to the criteria of a finance lease. The new criteria for a finance lease are as follows:

1. The lease transfers ownership of the underlying asset at the end of the lease term.
2. The lease grants the lessee an option to purchase the underlying asset and the lessee is reasonably certain to exercise that option.
3. The lease term is for the major part of the remaining economic life of the underlying asset. This criterion shall not be used for classification purposes if the commencement date falls at or near the end of the asset's economic life. (The previous guidance specified "75%" instead of "the major part" in this item.)
4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset. (The previous guidance specified "90%" instead of "substantially" in this item.)
5. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term. (This is a new item.)

The changes to this list might seem minor, but they have major ramifications. Specific figures gave some lease participants the ability to find loopholes and classify their contracts as operating leases. By removing these figures, FASB is introducing judgment that has to be supported.

Lessees with operating leases face the biggest change with the adoption of Topic 842. Including a lease on your balance sheet will show more assets and liabilities for your company or organization. Since the right of use assets will usually decrease at a faster rate than the lease liabilities, these values will change disproportionally—ultimately leading to having more liabilities than assets (if not already the case).

This, in turn, can affect how banks and other creditors view your financial situation. For example, they could see your organization as out of compliance with your debt covenant, which means that you're technically in default of your loan.

Lessors, on the other hand, are not terribly affected by Topic 842. The main difference is that, as the provider of the lease contract, they should work with lessees to review terms and renewal options and make sure the lease follows the new lease and revenue recognition standards.

What Steps Should You Take?

Topic 842 does not take effect for a couple of years, and although early implementation is permitted, it is not recommended. The intervening time should be used to take stock of existing leases and debt agreements and assess the effects of the new standard, including determining present value and other calculations needed for accounting under the new standard, working with banks or other creditors to ensure the new reporting will not adversely affect debt terms, and ensuring any new or renegotiated lease agreements have terms that are satisfactory to management and ownership.

You can take the following measures to ensure you're prepared for this new standard:

For existing leases:

1. Look at ongoing leases that will still be in effect when standards are implemented. You'll need to retrospectively show the effects of the new standard on your financial statements.
    a. Figure out if your net assets/equity would change if the standard were in effect in previous years.
    b. Update the net assets/equity for every year presented on your financial statements to reflect the new standard.
2. Determine when your lease(s) will expire. For leases ending before implementation, decide if you'll renew and, if so, how you want the terms to read.
    a. Will you set it up as a finance lease or operating lease?
    b. What will the new lease term be?
    c. What is the present value of such a renewal? (If you are reasonably certain that renewal terms will be exercised, you **MUST** consider the renewal as part of the lease term.)
4. If a lease will be ongoing at the time of implementation, get started on the math.
    a. Determine whether any renewal options will be exercised.
    b. Determine the present value of the remaining payments over the lease term, including renewal periods.
    c. Determine a tracking system for your leases to make sure the right of use assets and lease liabilities are going to be decreased by the appropriate amounts over the lease term. The amounts differ by lease type and based on the payment terms, so start calculations early.

For new/upcoming leases:

1. Make sure lease terms account for the new standard's changes. (You might decide to not include renewal terms in new leases to avoid additional calculations.)
2. Choose the type of lease (operations or finance). Hint: A company can make an election so leases with a lease term of less than a year do not require implementation of this accounting standard. The lease would be considered an operating agreement and the rent paid would be listed under operating expenses.

For all leases and other contracts:

1. Implement a tracking mechanism for each lease that documents your annual rent payments and includes per-fiscal year information such as expenses, liabilities, right of use (ROU) asset values, cash payments and more. This gives you a way to make sure your year-end numbers are correct during the lifetime of your lease.
2. Check your organization's debt agreements and their debt covenants. Then discuss with your bank or creditor to see if any modifications can and should be made to protect your standing with them.

Understanding the finer points of lease types is no easy task. But it's an essential part of managing your financial situation if you engage in any kind of leasing contract. Taking these steps is the prudent move to keep your leases in compliance with Topic 842 and ensure that your organization is protected.

Tax implications regarding Topic 842 will be addressed in a future article.