

FASB In Focus

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

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).

“The new guidance responds to requests from investors and other financial statement users for a more faithful representation of an organization’s leasing activities,” stated FASB Chair Russell G. Golden. “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.

“The guidance also reflects the input we received during our extensive outreach with preparers, auditors, and other practitioners, whose feedback was instrumental in helping us develop a cost-effective, operational standard,” added Mr. Golden.

Why Did the FASB Embark on a Project to Improve Financial Reporting of Leases?

Under the current accounting model, an organization applies a classification test to determine the accounting for the lease arrangements. Some leases are classified as capital leases (for example, a lease of equipment for nearly all of its useful life) whereby the lessee would recognize lease assets and liabilities on the balance sheet.

Other leases are classified as operating leases (for example, a lease of office space for 10 years) whereby the lessee would not recognize lease assets or liabilities on the balance sheet.

The existing operating lease model has been criticized for failing to meet the needs of users of financial statements because it does not always provide a faithful representation of leasing transactions.

The U.S. Securities and Exchange Commission (SEC) issued a report on off-balance sheet activities in 2005 that recommended that changes be made to the existing lease accounting requirements to ensure greater transparency in financial reporting. A number of other studies have made similar recommendations.

In 2006, the FASB and the International Accounting Standards Board (IASB) embarked on a joint

\$1.25 TRILLION of off-balance sheet operating lease commitments for SEC registrants*

*Estimate according to the 2005 SEC report on off-balance sheet activities.

project to improve the financial reporting of leasing activities.

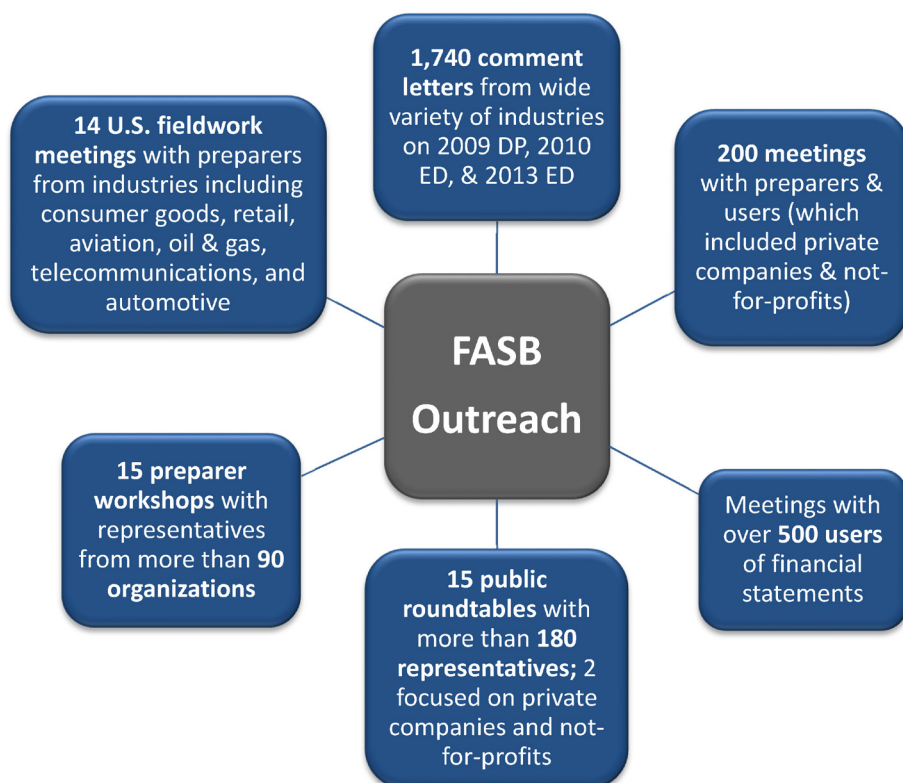
Since that time, the FASB and the IASB have issued three documents for public comment:

1. The 2009 Discussion Paper (2009 DP)
2. The 2010 Exposure Draft (2010 ED) and
3. The 2013 Exposure Draft (2013 ED).

Together, the documents generated more than 1,700 comment letters.

What Kind of Outreach Did the FASB Undertake When Developing the ASU?

When developing the ASU, the FASB participated in extensive outreach activities and received significant input from a wide variety of stakeholders. Outreach activities are summarized below:



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' exposure 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 flows 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.

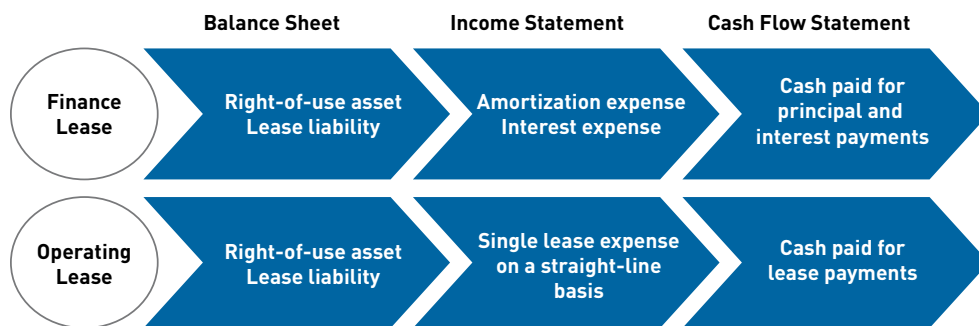
The ASU also will require disclosures to help investors and other financial statement users better understand the amount, timing, and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, providing additional information about the amounts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



Does the FASB's New ASU Differ from IFRS?

The leases project began as a joint project with the IASB. The IASB issued IFRS 16, *Leases*, in January 2016. The FASB and the IASB have reached the same conclusions in many areas of lease accounting, including requiring leases to be reported on the balance sheet, how to define a lease, and how lease liabilities are initially measured.

The main differences between this ASU and IFRS 16 relate to certain aspects of the lessee accounting model. In contrast to the lessee accounting model in the ASU, which distinguishes between finance leases and operating leases in the financial statements, the lessee accounting model in IFRS 16 requires leases to be accounted for consistent with the approach for finance leases in the ASU.

Consequently, leases classified as operating leases under the guidance in the ASU will be accounted for differently under GAAP than under IFRS and will have a different effect on the statement of comprehensive income and the statement of cash flows.

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 (with an exception for those entities that have not yet issued their financial statements or made financial statements available for issuance as of June 3, 2020)
3. An employee benefit plan that files or furnishes financial statements to the SEC.

For not-for-profit entities that have issued or are a conduit bond obligor for securities that are

traded, listed, or quoted on an exchange or an over-the-counter market that have not yet issued financial statements or made financial statements available for issuance as of June 3, 2020, for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years.

For all other organizations, the ASU is effective for fiscal years beginning after December 15, 2021, and for interim periods within fiscal years beginning after December 15, 2022.

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 described 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.

For more information about the project, please visit the FASB's website at www.fasb.org.