NEW STANDARD CHANGES ACCOUNTING FOR LEASES

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After a series of deferrals, the new lease standard, Topic 842, is here. Your organization may be unsure how this will affect your day-to-day activities, but I can assure you, it is not something to put off or deal with at the end of the year as part of your closing process. Read on for a better understanding of what Topic 842 means for your organization, and how you should be monitoring it throughout the year.

HISTORY

FASB accounting standards codification (ASC) 842 was created by ASU No. 16 and issued in February 2016. The standard supersedes FASB ASC 840. Prior to 840, a loophole allowed for financial statement manipulation using off-balance sheet transactions, which led to some well-known accounting scandals in 2000—think Enron.

ASC 840 applied a classification test to determine the accounting for a lease. If substantially all the benefits and risks associated with the asset were transferred to the lessee, the lease would be considered a "capital lease" and recorded as such on the balance sheet. If it did not meet one of four criteria, it was considered an "operating lease" and avoided the balance sheet altogether.

Even after ASC 840 was put in place, off-balance sheet transactions continued. But because operating leases are not included on the balance sheet, the effects of these contracts have been excluded from financial ratios and metrics used to measure an organization's health. Financial statement users have criticized the prior rules, and rightfully so. Operating leases are contracts in which one party has committed to paying another party for an asset for a specified period of time.

UNDERSTANDING LEASES & DISTINCTIONS

It is important to understand how a lease is defined, and certainly helps if you know the difference between what was a capital lease—now called a "financing lease"—and an operating lease. Historically, a lease was defined as an agreement conveying a right to use property, plant, or equipment, usually for a stated period of time. To be considered a capital lease, the lease had to meet one of four criteria:

1. The asset transferred ownership at the end of the term.

2. There was an option to purchase the asset at a discounted price at the end of the term.

3. The term of the lease was greater than or equal to 75 percent of the useful life of the asset.

4. The present value of the lease payments was greater than or equal to 90 percent of the assets' fair market value.

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If any one of the four conditions was met, the asset was capitalized at its present market value and a corresponding lease liability recorded. Depreciation would be recorded to reduce the asset value and as payments were made, the associated liability would be relieved. If the lease was not capital, then it was classified as operating. No additional accounting was needed for the operating lease; it would be expensed as paid each period.

ASC 842 changes the definition of a lease to 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. This new definition requires, substantially, all leases to be added to the balance sheet.

Whether it's a building, a vehicle, or another asset being leased, you can expect to see that on your balance sheet as an asset and a corresponding liability for the total lease liability, with some exceptions. The new lease standard freshens up the terms for what we now know as financing leases. Operating leases remain as operating leases. "Short-term" lease is another category.

THE FINANCE LEASE

The ASC 842 standard scrapped the specific percentages associated with tests numbered 3 and 4 above, called "bright-line" tests, and added less specific language and a fifth test. That's not to say that the organization cannot continue to use 75 percent and 90 percent as guides, but they are not specifically stated as the measurements.

To be a finance lease, the lease must meet at least one of the following criteria:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease contains a purchase option that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the the remaining economic life of the asset.
- The present value of the lease payments and residual value guaranteed by the lessee equals or exceeds substantially all the fair value of the underlying asset.
- The asset is specialized and expected to have no alternative use to the lessor at the end of the lease term.

As you might have noticed, the finance lease is similar to the previous capital lease.

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THE OPERATING LEASE

Notably, ASC 842 does not change the definition of an operating lease. Instead, it indicates that a lease is operating if it's not a finance lease. However, even though the definition has not changed, changes in how an operating lease is measured and recognized are dramatic.

SHORT TERM LEASES

Short-term leases are defined as leases that are less than 12 months and do not include an option to purchase the asset. In these cases, the organization can elect not to apply the new standard. But don't think you can avoid recognizing leases under the new standard by making them all less than 12 month. If there is an option to extend the lease beyond 12 months, it is not considered a short-term lease.

RECOGNITION, MEASUREMENT AND PRESENTATION

If you currently know how to report the different leases, you will be comfortable with finance lease reporting. At the commencement of the lease, an asset and liability are recorded at the "present value" of the lease payments. The present value of the right-of-use (ROU) asset and lease liability are discounted at the rate implicit in the lease, or the incremental borrowing rate if there is no known rate implicit in the lease. The standard calls the asset an ROU asset. Don't be intimidated by the language; it simply means the organization has a right to use the asset. Each year after initial recognition the organization will make three entries: one entry to amortize the ROU asset on a straightline basis over the life of the lease, one to record interest expense on the lease liability by increasing interest expense and also increasing the lease liability, and a third entry to record the cash payment and reduce the lease liability by the total of the lease payment (principal and interest). The income statement shows the lease activity through interest and amortization expense.

The recognition and measurement of the operating lease are more complicated. As mentioned above, historically this would involve only cash out and lease expense. Under Topic 842, the organization must record the ROU asset and related liability exactly the same as it would under a finance lease using the present value of the lease liability. After initial recognition, the the organization will increase the lease expense for the total of the lease payment (principal and interest), reduce the lease liability by the principal amount, reduce the ROU asset by the amortization amount, and record the cash payment.

Various calculations are required in the accounting. The lease expense will be recognized on a straight-line basis. The present value of the ROU asset and lease liability will be discounted at the rate implicit in the lease, or the incremental borrowing rate if there is no known rate implicit in the lease. Additionally, the amortization amount is not a consistent amount year to year, but rather, it is a balancing figure to get the operating lease expense constant over the life of the lease.

In the end, the income statement will look the same as it did under the former rules, with only the lease expense being affected. The full lease expense will be included in operating expenses.

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HOW TO PREPARE

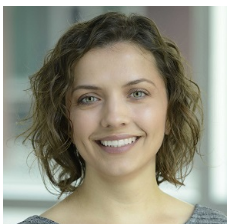
There are many variables to consider in contracts that may affect the treatment and determination of the lease. Additionally, there are accounting policies to review and practical expedients available to alleviate some of your burden of execution. It is important to start analyzing your organization's leases now, as this standard is in effect in for all organizations with a fiscal year beginning after December 31, 2021.

TO GET PREPARED

- Determine if the organization has qualified internal resources to take this project on. If not, consider hiring a consultant.
- Determine the organization's lease commitments. Start by analyzing the contracts you have in place. For example, the standard specifies that the asset must be identified in the contract; if the vendor has substitution rights, it might not be a lease.
- Prepare a template or document for calculating the ROU asset and lease liabilities, so you have the support to back up the balance recorded on the balance sheet and the associated amortization and interest expense or lease expense. If you have a significant number of leases, new software may be your best solution.
- Update policies and procedures and get your team trained.
- And, most importantly, call your accountants.

ABOUT THE AUTHORS

Darby is a Principal in the Naples, Florida office and has been with the firm since 2014. She is also the Regional Director of the Florida Assurance Practice. As Regional Director of the Assurance Practice, she is responsible for the growth and strategic direction of HBK's Assurance practice in Florida. Darby provides consulting, assurance, and business advisory services to clients in various industries. Her areas of specialization include a variety of accounting, tax, and assurance services, primarily for nonprofit and construction industries.



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