Overview of the FASB Accounting Standards Update on Leases

By Lisa Wabby, Senior Manager

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) on financial reporting for leasing transactions. The ASU amends the FASB Accounting Standards Codification by creating Topic 842, Leases. The key change in Topic 842 is that the standards now require organizations that lease assets to recognize on the statement of financial position the assets and liabilities for the rights and obligations created by the leases for all leases with lease terms of more than 12 months.

The new standard 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. Similar to the current accounting model, there are two classifications of leases in the new standard. Previously the classes of leases were operating and capital; the new classes of leases are operating and finance. The distinction between the classes of leases in the new standard is very similar to the existing lease standards.

A lease qualifies as a finance lease if one of the following is met:

1. Ownership transfers to the lessee at the end of the lease
2. The lease includes a purchase option that the lessee is reasonably certain to exercise
3. The lease term is a major part of the remaining useful life of the lease
4. The present value of the lease payments exceeds substantially all of the fair value of the underlying asset
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

Under the new standard, both classes of leases will create a right-of-use asset and a lease liability for each agreement that meets the lease definition. The initial measurement of both classes of leases uses the same calculation and accounting treatment. The lease liability will be measured based on the present value of lease payments not yet made, discounted using the discount rate for the lease at commencement. The right-of-use asset will be recognized based on the initial lease liability, plus payments made before or at lease commencement and initial direct costs. For the discount rate, if the lessee is not a public business entity, it can either elect to use the risk-free rate corresponding to the term of the lease or it can use the implicit rate of the lease, if known. If unknown, it can use the organization's incremental borrowing rate.

Reporting in the statement of activities and the subsequent measurement of leases differs between the classes of leases. For operating leases, lease expense will be recognized on a straight-line basis over the remaining lease term. The subsequent measurement of the operating lease liability will be the present value of lease payments not yet made using the initial discount rate. The right-of-use asset for operating leases will be measured at the current lease liability plus prepaid or less accrued lease payments, plus the remaining balance of any lease incentives and unamortized initial direct costs. For finance leases, organizations will amortize the right-of-use asset over the lease term or over the asset's useful life if the lease transfers ownership of the underlying asset to the lessee, or if the lessee is reasonably certain to exercise an option to purchase the asset. Lessees will subsequently account for finance lease liabilities at the initial lease liability plus interest on the liability less payments made, and subsequently account for financial lease right-of-use assets at cost less accumulated amortization.

The impact on the financial statements are summarized in the chart on the following page.

Financial Statement	Finance Leases	Operating Leases
Statement of Financial Position	Right-of-use asset Lease liability	Right-of-use asset Lease liability
Statement of Activities	Amortization expense Interest expense	Single lease expense on a straight-line basis
Statement of Cash Flows	Cash paid for principal and interest payments	Cash paid for lease payments

In addition, the ASU requires quantitative and qualitative disclosures to help financial statement users better understand the amount, timing, and uncertainty of cash flows from leases.

Lessor accounting will not change significantly. However, the ASU does contain improvements intended to better align lessor accounting with lessee accounting and with the updated revenue recognition guidance issued in 2014.

Action Items for Consideration

- Work to obtain a complete listing of all existing lease agreements.
- Develop procedures to have all responsible parties in your organization report all new agreements to the finance department so they can be evaluated for possible leases.
- Evaluate the potential impact this change on your statement of financial position may have on your organization's debt covenants.
- Decide when your organization will implement the new standard. The effective date for a not-for-profit entity 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 is fiscal years beginning after December 15, 2018. For all other not-for-profit entities, the amendments are effective for fiscal years beginning after December 15, 2019. Early adoption is permitted. Transition will require application of the new standard at the beginning of the earliest comparative period presented.
- Decide which practical expedients and accounting policies your organization will adopt, including:
    - Transition guidance: When implementing the new standard, an organization can apply the following practical expedients to leases that commenced before the effective date:
        - Not reassess whether any expired or existing contracts are or contain leases
        - Not reassess the lease classification for any expired or existing leases
        - Not reassess initial direct costs for any existing lease

      The above must be elected as a package and applied to all existing leases. In addition, an organization may also elect to use hindsight in determining the lease term for all existing leases (for example, when considering lessee options to extend or terminate the lease and to purchase the underlying asset) and in assessing impairment of the right-of-use asset.
- Short-term leases: As an accounting policy, a lessee may elect not to apply the recognition requirements in the new standard to short-term leases (leases less than 12 months). Instead, a lessee may recognize the lease payments in profit or loss on a straight-line basis over the lease term.
- Discount rate: If the lessee is not a public business entity, it can either elect to use the risk-free rate corresponding to the term of the lease, or it can use the implicit rate of the lease, if known, and if unknown, the organization's incremental borrowing rate.
- An accounting policy election can be made by class of asset not to separate lease components from nonlease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

If you have any questions about how this may affect your organization or need assistance with any of the action items above, please contact us.

About the Author

Lisa Wabby, Senior Manager
lwabby@capincrouse.com
o 630.682.9797, ext. 1220

Lisa joined CapinCrouse in July 2006. She has acquired a broad range of experience through serving a variety of clients within the nonprofit industry, including churches, colleges, foundations, foreign mission organizations, and voluntary health and welfare organizations. As senior manager, Lisa is responsible for the day-to-day supervision of staff assigned to the engagement. She is also the primary liaison between all individuals involved in the audit process, ensuring that the audit team is communicating well with client personnel in order to facilitate efficient and effective audit services.

About CapinCrouse

As a national full-service CPA and consulting firm devoted to serving not-for-profit organizations, CapinCrouse provides professional solutions to organizations whose outcomes are measured in lives changed. Since 1972, the firm has served mission-focused not-for-profit organizations, churches, and higher education institutions by providing support in the key areas of financial integrity and security. With a network of offices across the nation, CapinCrouse has the resources of a large firm and the personal touch of a local firm. Learn more at capincrouse.com.

.