

New FASB Guidance on Accounting for Leases



ARTICLE 03.01.16 DEAN DORTON

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued its new lease accounting guidance in Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*.

The ASU will require organizations that lease assets to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases, unless the lease is a short term lease.

Short term leases

A short term lease is defined in the ASU as “a lease that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is *reasonably certain* to exercise”. The lease term is defined as the noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following:

- Periods covered by an option to extend the lease if the lessee is *reasonably certain* to exercise that option.
- Periods covered by an option to terminate the lease if the lessee is *reasonably certain* not to exercise that option.
- Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.

For short term leases, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

Leases not considered short term

For all other leases, the lessee will be required to recognize the following at the commencement date of the lease:

- A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and
- A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

When measuring assets and liabilities arising from a lease, a lessee (and a lessor) should include payments to be made in optional periods only if the lessee is *reasonably certain* to exercise an option to extend the lease. Similarly, optional payments to purchase the underlying asset should be included in the measurement of lease assets and lease liabilities only if the lessee is *reasonably certain* to exercise that purchase option. *Reasonably certain* is a high threshold. In addition, a lessee (and a lessor) should exclude most variable lease payments in measuring lease assets and lease liabilities, other than those that depend on an index or a rate or are in substance fixed payments.

Consistent with current Generally Accepted Accounting Principles (GAAP), the recognition, measurement, and presentation in the statements of income and cash flows will depend on the lease's classification as a finance or operating lease.

- For finance leases, a lessee is required to:
 - Recognize interest on the lease liability separately from amortization of the right-of-use asset in the statement of income.

- Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows
- For operating leases, a lessee is required to:
 - Recognize a single lease cost in the statement of income (which will include both the amortization of the right-of-use asset and the “interest” element associated with the lease liability), calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis.
 - Classify all cash payments within operating activities in the statement of cash flows.

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.

Lessor accounting

Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, *Revenue from Contracts with Customers*.

Sale and leaseback transactions

The new lease guidance also simplified the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees will no longer be provided with a source of off-balance sheet financing.

Effective dates

Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Nonpublic business entities should apply the amendments for fiscal years beginning after December 15, 2019 (i.e., year ending December 31, 2020 for a calendar year entity), and interim periods within fiscal years beginning after December 15, 2020. Early application is permitted for all public business entities and all nonpublic business entities upon issuance.

Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach.

If you have any questions regarding this new standard or would like assistance in implementing the new standard, please contact your Dean Dorton advisor, or:

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