Here Come the New Lease Rules!!

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Some of you may not have heard, but the Financial Accounting Standards Board (FASB) has issued new accounting requirements for leases (ASC 842) that become effective in 2019 for public companies and 2020 for nonpublic companies. The accounting rules can be early applied and must be retroactively applied in comparative statements, so understanding the new lease rules and the impact on financial statements is imperative.

As in previous standards, there are two types of leases, finance leases, which are essentially capital leases, and operating leases. The big change is that ASC 842 requires that operating leases be reported on the balance sheet, recognizing a right-of-use asset and a lease liability for virtually all operating leases.

The first step in applying ASC 842 is determining whether an arrangement contains a lease. In order for a contract to be, or contain a lease, it must identify the asset and the lessee must receive the right to obtain substantially all of the economic benefits from the asset use and direct the uses of the asset over the lease term. This is called the right to control the use condition. Any agreement that looks like a lease, but is twelve months or less, is not considered a lease for these purposes. Once a contract is determined to be a lease, it needs to be identified as an operating or finance lease.

A lease would be considered to be a finance lease if any of the following five criteria are met:

1. It transfers ownership of the underlying asset to the lessee by the end of the lease term.
2. It grants the lessee an option to purchase the underlying asset and the lessee is reasonably certain to exercise.
3. The term is for the major part of the remaining economic life of the underlying asset, provided that the commencement date does not fall at or near the end of the economic life of the asset.
4. The present value of the sum of lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all the value of the underlying asset.
5. The underlying asset is of such specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

If none of the above five criteria are met, the lease would be classified as an operating lease.

Under the new standard, a finance lease is recorded using the financing model, recording the asset and finance obligation, and in which the expenses resulting from the lease decline during the lease term, with a reduction in interest expense as payments are being made and recording straight-line amortization. For operating leases, the right-of-use asset and lease liability are determined by applying an interest factor to the payment stream. Lease expenses are recognized on a straight-line basis, by amortizing the leased asset on an increasing basis and recording interest expense on a decreasing basis, as payments are made so that the total lease expense is even over the term of the lease.

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It is not uncommon for a contract to contain both lease and non-lease components. An activity is a non-lease component if it transfers goods or services to the lessee, such as common area maintenance, service or maintenance agreements, or support and training. If the contract contains both lease and non-lease components, the lessee must allocate the payments to the leased asset based on the stand-alone selling price of the asset. If this allocation is not possible, then the entire payment stream will be included in the determination of the leased asset and the lease liability.

These changes to lease reporting are significant and if a company has longer term leases, or uses leases extensively, the impact on the financial statements could be dramatic. The changes also may alter the way a lender looks at your financial statements. Being aware of these changes and preparing for them are key to proper recording and reporting.

At MichaelSilver, we help our clients prepare for change. For more information on the new lease accounting standard, please contact Jennifer A. Barliant, CPA, CGMA at 847.213.2062.

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