Lease Accounting Is Final –
Time to Prepare for Implementation

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued the long-awaited standard requiring lessees to recognize substantially all leases on their balance sheets as lease liabilities with a corresponding right-of-use asset. Accounting Standards Update (ASU) 2016-02, Leases (Topic 842), maintains the dual model for lease accounting with lease classification determined substantially in accordance with the guidance in existing lease requirements.

For public business entities, the new guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (i.e., January 1, 2019, for a calendar-year entity). Nonpublic business entities, including not-for-profit entities, should apply the new guidance for fiscal years beginning after December 15, 2019 (i.e., January 1, 2020, for a calendar-year entity) and interim periods within fiscal years beginning after December 15, 2020. All entities may adopt early.

The basic principle of the update is that leases of all types convey the right to direct the use and obtain substantially all the economic benefit of an identified asset, creating an asset and liability for lessees. (Note that ASU 2016-02 does not apply to leases of intangible assets; leases to explore for or use minerals, oil, natural gas, and similar non-regenerative resources; or to leases of biological assets, including timber, leases of inventory, or leases of assets under construction.)

Under the new standard, lessees will classify leases as either finance leases (comparable to current capital leases) or operating leases (comparable to current operating leases), with the related costs reported substantially as they are today.

Finance leases have front-loading of costs split between amortization and interest costs, while operating leases continue to list a single-level rental expense in the income statement. If the contract duration is equal to or less than 12 months (a short-term lease), then a lessee may make an accounting policy election by class of underlying asset to maintain the off-balance-sheet approach currently used for operating leases.

To help mitigate debt covenant concerns, the operating lease liability will not be classified as debt, but rather as an operating obligation (or “other” liability) and generally will not trigger a technical default under a lessee’s debt limit covenants. Lessor accounting essentially will follow today’s accounting model for sales-type, direct financing, and operating leases, while new guidance will align to the new revenue recognition standard.

This article will identify the scope of the final regulations and present considerations for lessees (e.g., contractors) and lessors (e.g., equipment leasing companies) to prepare for the new standard. See Exhibit 1 on the following page for a comparison on legacy and new lease accounting.

Lessee Accounting

The new rules may significantly affect an individual lessee’s statement of financial position by increasing lease-related assets and liabilities. The dual model, however, limits the changes’ impact on the income statement and statement of cash flows compared to today’s standards.

As noted, lessees will maintain substantially the same expense recognition patterns for operating leases and finance leases (existing capital leases) as under existing standards. Changes come in terms of the balance sheet and ongoing lease administration.

Lessees will classify leases in accordance with the principal in existing lease requirements by determining whether the lease is effectively an installment purchase. Today’s capital leases will be classified as finance leases, while today’s operating leases will retain their classification.

For leases entered into subsequent to transition, the amounts initially recorded on the balance sheet will be the same regardless of whether the lessee classifies the lease as a financing or an operating lease. The accounting difference between operating and finance leases occurs in the subsequent recognition of lease-related expense and measurement of the lease asset.
### Exhibit 1: Legacy vs. New Lease Accounting Comparisons

#### Financing Leases

<table>
<thead>
<tr>
<th></th>
<th>Legacy GAAP (Capital Leases)</th>
<th>ASU 2016-02 (Finance Leases)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Recognition</strong></td>
<td>Lease assets and liabilities on balance sheet</td>
<td>Yes</td>
</tr>
<tr>
<td>Exemption for short-term leases</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Measurement</strong></td>
<td>Lease liabilities measured on a discounted basis</td>
<td>Yes</td>
</tr>
<tr>
<td>Initial lease asset = lease liability</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Amortization of lease asset</td>
<td>Presented separately from owned assets, or presented together with the corresponding underlying assets as if they were owned, with disclosure of the line items that contain the capital lease assets and their amounts</td>
<td>Presented separately from owned assets, or presented together with the corresponding underlying assets as if they were owned, with disclosure of the line items that contain the finance lease right-of-use assets and their amounts</td>
</tr>
<tr>
<td><strong>Presentation</strong></td>
<td>Lease assets</td>
<td>Presented separately from owned assets, or presented together with the corresponding underlying assets as if they were owned, with disclosure of the line items that contain the capital lease assets and their amounts</td>
</tr>
<tr>
<td></td>
<td>Lease liabilities</td>
<td>Presented separately from other liabilities, or together with other liabilities with disclosure of the balance sheet line items that include the capital lease liabilities and their amounts</td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
<td>Lease-related costs</td>
<td>Amortization of lease assets and lease-related interest expense presented separately</td>
</tr>
<tr>
<td><strong>Cash Flow Statement</strong></td>
<td>Operating activities</td>
<td>Cash payment for the interest portion of the lease liability</td>
</tr>
<tr>
<td></td>
<td>Financing activities</td>
<td>Cash payments for the principal portion of the lease liability</td>
</tr>
</tbody>
</table>

#### Operating Leases

<table>
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<tr>
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<tr>
<td><strong>Balance Sheet</strong></td>
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<td></td>
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<tr>
<td><strong>Recognition</strong></td>
<td>Lease asset and liabilities on the balance sheet</td>
<td>No</td>
</tr>
<tr>
<td>Exemption for short-term leases</td>
<td>N/A</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Measurement</strong></td>
<td>Lease liabilities measured on a discounted basis*</td>
<td>N/A</td>
</tr>
<tr>
<td>Initial lease asset = lease liability</td>
<td>N/A</td>
<td>Yes</td>
</tr>
<tr>
<td>Amortization of lease assets</td>
<td>N/A</td>
<td>Periodic amortization expense typically increases with time**</td>
</tr>
<tr>
<td><strong>Presentation</strong></td>
<td>Operating right-of-use assets</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>Lease liabilities</td>
<td>Presented separately from finance lease liabilities</td>
</tr>
<tr>
<td><strong>Income Statement</strong></td>
<td>Lease-related costs</td>
<td>Single lease or rent expense, generally straight-line</td>
</tr>
<tr>
<td><strong>Cash Flow Statement</strong></td>
<td>Operating activities</td>
<td>Cash payments for lease payments</td>
</tr>
</tbody>
</table>

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* Lease liabilities initially are recognized at the present value of lease payments.
** On a periodic basis, lessees measure lease assets at an amount that achieves the recognition of a single lease expense typically on a straight-line basis.
For operating leases, lessees will recognize a single lease expense, generally on a straight-line basis over the lease term. Interest on the lease obligation will be added to the lease asset balance (as opposed to being presented on the income statement) to avoid presenting the transaction as a financing transaction. The lease asset balance is reduced each period by the difference between the straight-line lease expense and interest cost on the lease liability. Finance leases are accounted for in a manner similar to today’s capital leases.

At commencement of a lease, lessees will measure the lease asset at the same amount as the lease liability (the total discounted rent obligation under the lease), adjusted for initial direct costs related to entering into the lease, accrued or prepaid rent, and lease incentives. Only variable lease payments dependent on an index or a rate should be included in the initial measurement of lease assets and liabilities; these should be measured using the index or rate at lease commencement.

Unless the rate implicit in the lease is reasonably determinable, lessees will use their incremental borrowing rate as the discount rate. Lessees that are not public business entities may make an accounting policy election to use a risk-free rate for initial and subsequent measurement of lease liabilities.

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 the renewal option or not exercise the termination option, or in cases where the exercise of those options is controlled by the lessor. This is an important consideration for leases with a term of 12 months or less and a history of ongoing renewal.

Lessees will present finance and operating leases as separate line items on the balance sheet or disclose in the notes which line items in the balance sheet include finance and operating lease assets. Finance and operating leases cannot be presented in the same line item; lease liabilities have the same separation requirements.

**Transition**

ASU 2016-02 allows companies to apply the leases guidance at a portfolio level and elect transition reliefs, termed “practical expedients,” and provides guidance to help entities comply with implementation.

Transition reliefs include forgoing the requirement to review existing contracts for lease arrangements and evaluate classification for existing leases, as well as the requirement to identify initial direct costs for leases that commence before the effective date, as well as the ability to use hindsight in evaluating lessee options to extend or terminate a lease or purchase the underlying asset. Lessees and lessors are required to use a modified retrospective transition method for existing leases, which correlates lease classification under ASC Topic 840 to the new classifications under ASC Topic 842. Entities would apply the new standard to the earliest period presented.

An organization electing to apply the practical expedients essentially will continue to account for leases that commence before the effective date in accordance with current GAAP, unless the lease is modified. This means, if elected, capital leases will maintain their existing value at transition. For operating leases, lessees will measure and recognize lease assets and liabilities at each reporting date based on the present value of the remaining minimum rental payments over the life of the lease as tracked and disclosed under current GAAP.

If comparative statements of financial position are presented at transition, then entities would measure and recognize leases at the beginning of the earliest period presented – 2018 for public companies and 2019 for all other entities. Three years of comparative statements of comprehensive income (required in some circumstances) would require recording under the new standard as early as 2017 for public companies and 2018 for all other entities.

ASU 2016-02 includes specific transition guidance for sale and leaseback transactions, build-to-suit leases, leveraged leases, and amounts previously recognized in accordance with the business combinations guidance for leases.

**Definition & Scope of a Lease**

The definition of a lease has changed, and both parties to a contract may need more resources to identify existing leases and structure new leases. Based on the new definition, a lease is present only when a contract or part of a contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset; the example used in the standard is “the number of production units that an item of equipment will be used to produce.”

Under the lessee accounting model in previous GAAP, the critical determination was whether a lease was a capital or an operating lease, as lease assets and liabilities were recognized only for capital leases. Under Topic 842, the critical determination is whether a contract is or contains a lease, as lessees are required to recognize lease assets and liabilities for all
leases – finance and operating – other than short-term leases (i.e., if the entity elects the short-term lease recognition and measurement exemption).

**Right to Control the Use of an Identified Asset**

The right for the lessee to control the use of an identified asset is determined by assessing whether, throughout the period of use, the lessee has both:

- The right to direct the use of an identified asset; and
- The right to obtain substantially all the economic benefits from directing its use.

Entities must consider all relevant facts and circumstances; they may conclude the customer has the right to control the use of an identified asset only for a portion of the contract term, meaning the contract would contain a lease for that portion of the term.

An identified asset may be explicitly identified in the contract or implicitly specified at the time the asset is made available for use by the customer.

**Right to Direct the Use of an Identified Asset**

Based on the new guidance, a customer has the right to direct the use of the identified asset throughout the period of use in either of the following situations:

- **a)** The customer has the right to direct how and for what purpose the asset is used throughout the period of use.
- **b)** The relevant decisions about how and for what purpose the asset is used are predetermined and at least one of the following circumstances exists:
  - The customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use without the supplier having the right to change those operating instructions, or
  - The customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

A customer has met criteria **a)** if, within the scope of its right of use as defined in the contract, it can decide to change how and for what purpose the asset is used throughout that period. The decision-making rights that affect the economic benefits to be derived from use are the most relevant.

Protective rights represent terms and conditions designed to protect the supplier/lessor’s interest in the asset, to protect its personnel, or to ensure the supplier’s compliance with laws or regulations. Although protective rights typically define the scope of the customer’s right of use, they do not, in isolation, prevent the customer/lessee from having the right to direct the use of an asset.

**Substantive Substitution Rights**

Even if an asset is specified, a customer/lessee may not meet the criteria for having the right to use the identified asset. This occurs when the supplier/lessor has the substantive right to substitute an asset throughout the period of use.

A substantive right occurs when the supplier has the practical ability to substitute alternative assets throughout the period of use and would benefit economically from the exercise of its right to do so. An entity should evaluate whether a supplier/lessor’s substitution right is substantive based on facts and circumstances at inception of the contract, excluding consideration of future events that, at inception, the entity did not consider likely to occur.

An asset that is a portion of a larger asset is an identified asset if it is physically distinct (e.g., a floor of a building or a segment of a pipeline connecting a single customer to the larger pipeline).

**Right to Obtain Substantially all Economic Benefits from Use of the Identified Asset**

To meet the definition of a lease, a customer also is required to have the right to obtain substantially all of the economic benefits from use of the identified asset throughout the period of use (e.g., by having exclusive use of the asset throughout the period).
A customer can obtain economic benefits from use of an asset directly or indirectly, such as by using, holding, or subleasing the asset, and includes the asset’s primary output and byproducts, including potential cash flows derived from these items and other economic benefits from using the asset that could be realized from a commercial transaction with a third party.

**Separate Nonlease Components**

An entity is required to separate lease and nonlease components of a contract. Lessees will allocate the consideration on a relative standalone price basis – unless they make an accounting policy election – by class of underlying asset, in order to avoid separating lease components from nonlease components.

If the election is made, then a lessee should account for lease and nonlease components together as a single lease component. If the election is not made, then consideration attributable to nonlease components is not included in the measurement of lease assets or lease liabilities, and the entities would account for the nonlease payments in accordance with other guidance.

**Implementation & Planning Considerations**

Although the effective dates seem years away, entities impacted by the leases standard should start preparing for this transition now.

Leases executed prior to the effective date will be subject to the new standard; therefore, current leasing arrangements that have lease terms extending at least 12 months beyond the effective date will be accounted for under the new standard. In addition, if your company prepares comparative statements, then the new standard will be applied to the earliest comparative period presented.

**Lessees Considerations**

Companies should begin by taking an inventory of all arrangements within the scope of the new leases standard and gathering the required information. The definition of a lease determines that population; as shown in the example a few pages ahead, entities will need adequate time to evaluate agreements against the multipart definition of a lease.

Accounting for operating leases may not have required significant effort up to now, since only footnote disclosures were required. To comply with the new leases standard, however, significant manual effort may be required to gather additional lease information and determine completeness of the lease portfolio.

For example, although the data requirements for measuring operating leases are similar to those required for disclosures of today’s operating leases, with the exception of discount rates, lessees may not have separated lease and nonlease components of a contract and allocated consideration paid. Lessees may be accounting for leases embedded in a service agreement as a single contract since their accounting treatment is often the same, and these agreements may not be included in existing lease disclosures.

In addition to defining the population, entities will want to understand their current state of leasing activities, including system capabilities. Existing lease administration applications (often spreadsheets) may include some lease information, but they may not have the information necessary for asset and liability measurement and compliance with the comprehensive qualitative and quantitative disclosure requirements.

For accounting purposes, lessees might be incorporating capital lease assets into fixed-asset software, while keeping existing operating lease assets off the books. Since lessees will amortize right-of-use assets for operating leases differently than finance leases, the most affected entities might consider investing in lease accounting software to capture the lease population and meet the accounting requirements.

Entities will want to identify new lease information requirements, including additional qualitative and quantitative disclosures, and compare this to existing processes, policies, controls, and system information-gathering capabilities.

A lessee needs the same information to apply both lease accounting models. This will require developing consistent processes around judgments and estimates necessary to evaluate whether an arrangement contains a lease; separate lease and nonlease components of a contract; and determine lease payments to be capitalized, lease term, and discount rate. Processes and systems will need to capture events that require reassessments or consider when entities should reallocate the consideration in a contract upon a contract modification not accounted for as a new, separate contract.

Entities can then develop a plan to fill any gaps and implement new processes, policies, controls, and systems to capture pertinent lease data and comply with the new requirements.

**Financial Ratios**

For lessees with current material off-balance-sheet leases, the most significant effect of the new leases standard will be a gross-up in the balance sheet by increased lease assets and...
financial liabilities. This would affect certain leverage/debt ratios and performance ratios (e.g., interest coverage and return on assets ratios).

An entity should assess the potential impact on its financial statements and metrics and evaluate how this may affect the way stakeholders view its financial position and performance. Lessees should discuss the new standard with their auditors and creditors with covenants to understand the implications.

**Lease Considerations**

From a balance sheet perspective, lessees will experience similar effects as if they were buying the asset. Lessees may focus more on getting the best deal for their company as opposed to ensuring the lease qualifies for operating lease classification, and expect to work more with lessors for favorable terms and cost savings.

In addition, lessees may need assistance in allocating consideration between the lease and non-lease components (which are not capitalized), with a desire to minimize the financial statement impact.

Determining whether a new contract is or contains a lease is the same regardless of the lease classification outcome. From an operational perspective, lessees still face lease vs. buy decisions, and most of the benefits of leasing remain intact (e.g., equipment upgrades or add-ons, service, matching payments to cash flow needs, potential low-cost financing compared to a loan, and residual risk transfer to avoid ownership of obsolete equipment).

From a financial statement perspective, the amount a lessee is required to capitalize under an operating lease (present value of minimum lease payments) is usually lower than the capitalized cost of purchasing an asset, and the lease liability is non-debt.

Parties to sale and leaseback transactions will work closely together to ensure a sale occurs considering revenue recognition guidance and the new leases guidance.

(For more on the topic of leasing vs. owning equipment, check out “Construction Equipment Leasing: Today & in the Future” by Todd A. Feuerman & Jared A. Rosen in the September/October 2015 issue.)

**Conclusion**

While this article covered the intricacies of identifying a lease as well as planning considerations, companies that are preparing to implement the new leasing standard should also evaluate lease recognition, measurement, presentation, and financial statement disclosure requirements, and other topics (i.e., subleases, sale and leaseback transactions, contracts with multiple components, contract combinations, and implementation considerations) before proceeding. ■

*Authors’ Note:* This article is for general information purposes only and is not to be considered as legal advice. Applying this information to your particular situation requires careful consideration of your specific facts and circumstances. Consult your advisor or legal counsel before acting on any matter covered in this article.

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**Save the Date: July 13, 2016**

Let’s analyze the new standard in a typical construction scenario.

Suppose a GC is hired to build an office building and enlists a subcontractor to erect a tower crane on the jobsite and provide crane operators. The GC enters into a 24-month contract (commonly referred to as an “embedded lease”) with Crane Operator, Inc., for a crane specified by the GC and crane operators.

The GC has exclusive use of the crane on the jobsite, including scheduling all contractors that need time to perform lifts (e.g., electrical, mechanical, and structural). The lease does not transfer ownership of the crane or grant the GC an option to purchase the crane.

Crane Operator, Inc., guarantees it will provide another crane identical to the one specified in the contract if it is not operational. The GC must approve any substitutions.

The GC, as the customer, and Crane Operator, Inc., as the vendor, will need to determine whether the contract is or contains a lease by assessing whether, throughout the period of use, the GC has the right to direct the use of an identified asset and obtains substantially all the economic benefits from directing its use. The parties will make this assessment considering all relevant facts and circumstances.

**Analysis & Identification**

The GC has the right to direct the use of a crane explicitly identified in the contract, in a manner that it determines. The supplier’s obligation to substitute the asset upon the occurrence of a specified event (e.g., the identified asset is inoperable) does not give it the practical ability to substitute alternative assets throughout the period of use.

Likewise, the supplier’s right or obligation to substitute an asset for repairs or maintenance if the asset is not operating properly does not preclude the customer from having the right to use the identified asset. The GC has the right to obtain substantially all of the economic benefits from use of the tower crane.

The agreement is a lease because the GC has the right to control the use of an identified asset throughout the period of use, in exchange for consideration.

The next step is to classify and measure the lease.

**GC Classification & Recognition**

As noted, the classification criteria for distinguishing between finance and operating leases are substantially similar to today’s classification criteria for distinguishing between capital leases and operating leases.

Since none of the criteria for a finance lease are met, the lease in this example is an operating lease. The portion of payments attributable to the crane operator is a non-lease component of the contract. Since payments for the crane operator are variable and do not depend on an index or rate, the lessee will pay for those service costs as incurred and does not have the option to account for both components as a single lease component.

The GC initially will capitalize as a lease right-of-use asset and lease liability at the same amount as if the lease was instead classified as a finance lease, based on the total discounted non-cancellable rent obligation under the lease.

The lease right-of-use asset is recorded as the same amount as the lease liability, adjusted for initial direct costs. The rate implicit in the lease is not reasonably determinable, so the GC will use its incremental borrowing rate as the discount rate.

The income statement effect of entering into the lease essentially is the same as under current rules. The GC will recognize a single lease expense, generally on a straight-line basis over the lease term, and will perform the same job costing as prior years.

The right-of-use asset is reduced each period by the difference between the straight-line lease expense and interest cost on the lease liability, determined using the effective interest method.

**Equipment Leasing Company Classification & Recognition**

The new guidance aligns the lease classification criteria for finance leases for lessors and lessees. Therefore, since the lease is not a finance lease for the lessee, it is not a sales-type lease by the lessor. By default, Crane Operator, Inc. also will classify the lease as an operating lease, since the lease doesn’t meet the criteria for a direct financing lease.

The accounting applied by a lessor is largely unchanged from that applied under previous GAAP, and the lessor will recognize the lease payments for the non-cancellable lease term as lease income.