

# FASB Lease Accounting Changes

In February 2016, the Financial Accounting Standards Board (the "FASB") issued a new lease accounting standard (Topic 842). The new lease accounting standard will impact financial reporting for entities that are required to report their financial results in accordance with U.S. generally accepted accounting principles. Topic 842 does not impact the tax treatment of leases. In addition, Topic 842 will not impact the many economic benefits realized by utilizing leasing as a source of financing. Leasing is still a great way to offer products to your customers and will continue to be an attractive financing option for your customers!

## Effective Dates

Topic 842 is effective for public companies for fiscal years beginning after December 15, 2018, and is effective for private companies one year later. Early adoption is permitted for all entities. Upon adoption, companies will be required to recognize and measure leases at the beginning of the earliest period presented in their financial statements. Although the new standard will be applied to all active leases at the time of transition, lessees may not be required to reassess lease classification upon transition.

## Lease Classification

The FASB did retain a dual lease classification model. In other words, the new lease accounting standard maintains the concept of a finance lease (formerly a capital lease), and an operating lease. There were minor changes made to the lease classification criteria, primarily to remove the "bright lines" that exist in the current standard. A summary of the changes to the lease classification criteria are detailed on the following table.

If a lease meets **ANY** one or more of the following:

CURRENT RULES (TOPIC 840, F/K/A FAS 13)... CAPITAL LEASE	NEW RULES (TOPIC 842)... FINANCE LEASE
Transfer ownership to lessee at end of term	Transfer ownership to lessee at end of term
Contains a bargain purchase option	Contains a purchase option the lessee is <b>reasonably certain</b> to exercise
Lease term equals 75% or more of the estimated economic life	Lease term is for the <b>major part</b> * of the remaining economic life
Present value of the minimum lease payments equals or exceeds 90% of the fair value	Present value of the lease payment equals or exceeds <b>substantially all</b> ** of the fair value
	<b>NEW...</b> Underlying asset is such a <b>specialized nature</b> that it is expected to have no alternative use to the lessor at the end of term

If a lease does **NOT** meet any of the above criteria, it is an operating lease.

\*One reasonable approach would be to conclude that 75% or more is a major part of the remaining economic life.

\*\*One reasonable approach would be to conclude that 90% or more is substantially all of the fair value.

This document is for informational purposes only. It is not intended as, nor does constitute, accounting advice. You should contact your own accounting advisors to determine how the new lease accounting standard will apply to your business and your equipment/software acquisition.

### What's Changing?

The main difference between the current standard and Topic 842 is the recognition of lease assets and lease liabilities by lessees for leases previously classified as operating leases. Although operating leases will be reported on-balance sheet, the lease liability is intended to be classified as an operating liability, rather than debt. Lessees should consult with their lenders to determine any potential impacts on their credit lines and covenants.

Topic 842 applies to all leases, except short term leases (i.e., lease term is 12 months or less). Real estate leases will likely have a larger impact than equipment leases due to the size of the transactions. Entities should also consider adopting reasonable capitalization thresholds, below which, lease assets and lease liabilities are not recognized.

A summary of the financial reporting requirements under the new lease accounting standard can be found on the following table.

LEASE TYPE	BALANCE SHEET	INCOME STATEMENT	STATEMENT OF CASH FLOWS
FINANCE LEASE (FORMALLY KNOWN AS A CAPITAL LEASE)	Right-of-Use Asset and Lease Liability (Debt)	Interest on Lease Liability and Amortization of ROU Asset	Principal repayments as Financing Activities, and interest as Operating Activity
OPERATING LEASE	Right-of-Use Asset and Lease Liability (Operating)	Single lease cost allocated over term, generally straight-line basis	Cash payments as Operating Activities
SHORT TERM LEASE	As an accounting policy election, lessees may elect to not apply the recognition requirements of Topic 842 to short term leases, which are defined as leases with a lease term of 12 months or less, AND does not contain a purchase option that the lessee is reasonably certain to exercise.		

■ Substantially the same as current guidance

■ Change from current guidance

### Bundled Transactions

In bundled lease transactions that include both equipment and service/maintenance, only the equipment portion of the lease is required to be reported on-balance sheet. This is consistent with the current guidance for a capital lease. The lessee would make this determination based on the relative standalone price of the lease and non-lease components on the basis of their observable standalone prices. A price is observable if it is the price that the supplier or a similar supplier would sell similar lease or non-lease components on a standalone basis. If observable standalone prices are not readily available, the lessee can estimate the standalone prices, maximizing the use of observable information.

### What's Next?

Many entities have begun the process of evaluating the potential impacts of the new lease accounting standard. In addition to consulting with lenders, lessees should also consider consulting with their auditors regarding how the new standard will impact their financial statements, and their technology and software providers regarding changes to support the new standard.

Please contact your GreatAmerica sales representative if you have any questions.