



April 2016

# Something Borrowed, Something New – Get Ready for the New Lease Accounting Standard

By Scott G. Lehman, CPA, and David E. Wentzel, CPA



Leasing is an important part of the operations of many organizations. For some organizations, leasing provides a means to finance its access to assets and minimize exposure to the risks of asset ownership. For organizations serving as lessors, leasing can provide a pathway to a long-term return on investment without having to relinquish ownership of the asset. Leases cross over many industries – including real estate, financial services, retail, manufacturing, distribution, aerospace, and transportation – as well as all types of organizations, including not-for-profits and public and private companies.

In fact, any organization that engages in lease contracts – for real estate, vehicles, or equipment, for example – will be affected by Accounting Standards Update (ASU) No. 2016-02, “Leases (Topic 842),”<sup>1</sup> which the Financial Accounting Standards Board (FASB) issued on Feb. 25, 2016. The lengthy standard alters existing U.S. generally accepted accounting principles (GAAP) in many ways, most prominently changing the way operating leases are currently accounted for by lessees. As a result, lessees will reflect most leases on the balance sheet – providing stakeholders with a more complete and comprehensible picture of an organization’s leasing activities and their effects on its financial statements.

## Background

The issuance of the new leases standard is the culmination of a long project aimed at improving the transparency of lease accounting. The standard got its start in 2006, when the FASB and the International Accounting Standards Board (IASB) added to their agendas a long-term project to reconsider the current lease accounting guidance. This project’s objective was to comprehensively reconsider the guidance in FASB Statement No. 13, “Accounting for Leases” (Topic 840), and International Accounting Standard (IAS) No. 17, “Leases” – together with their subsequent amendments and interpretations – to provide users with useful, transparent, and complete information about leasing transactions.

The FASB issued its first proposed ASU on the topic, “Leases (Topic 840),” in August 2010. Taking into account FASB- and IASB-held roundtable discussions and numerous comment letters and other feedback on the original proposal, the board issued a revised proposal in May 2013. On Nov. 11, 2015, the FASB concluded its deliberations on the revised proposal, taking into consideration the substantial feedback it received on the revised proposal, before issuing the final standard in February 2016.

## What You Need to Know Right Now

- Operating leases will be recorded on the balance sheet for lessees by establishing a lease liability and corresponding right-of-use (ROU) asset, which means that most leases will now be on the balance sheet.
- Lessee model:
  - Lessees will follow a classification approach similar to that of existing U.S. GAAP: finance leases (similar to today’s capital leases) and operating leases (similar to today’s operating leases).
  - There will be a difference between the expense recognition timing of finance leases and operating leases. Finance leases will result in front-loaded expense recognition, while operating leases will result in straight-line expense recognition.
  - There will be no bright-line lease classification tests.
  - There will be an accounting policy election alternative to not recognize short-term leases with a term of 12 months or less on the balance sheet.
- Lessor model:
  - Lessors will classify leases into one of three categories: sales-type, direct-finance, or operating.
  - Lessor classification provisions are consistent with the new revenue recognition standard.
- Effective dates and modified retrospective application may cause implementation challenges and resource constraints for organizations that need to adopt both the new leases standard *and* the new revenue recognition standard.

---

## Who Will Be Affected?

ASU 2016-02 replaces virtually all existing leasing guidance. As a result, the guidance affects all entities, whether lessees or lessors, that engage in leasing. The significance to an organization will depend on the nature of its leasing activities and the structure of its existing leases. For most organizations, the primary impact will be related to operating leases that are coming on the balance sheet for lessees. In addition, the new leases standard could affect organizations that measure compliance with debt covenants that are based on certain financial statement metrics, given that balance sheets will be grossed up for operating leases by lessees.

## How Does the New Standard Change Existing GAAP?

Until now, many organizations have viewed leasing as a form of off-balance sheet financing. Existing GAAP has been criticized for providing “bright line” thresholds to determine the accounting for a lease – thresholds that could lead to significantly different financial statement impacts for similar lease transactions.

The new standard is intended to increase transparency and comparability by requiring lessees to recognize the financial obligation and right-of-use (ROU) asset associated with operating leases that have a lease term of more than 12 months on the balance sheet. As a result, financial statement users will have more visibility to the long-term financial obligations of leases. With this change, most leases will be reported on the balance sheet by lessees.

### **Contracts That Are or Contain Leases**

Under the new standard, certain contracts will need to be assessed by both lessors and lessees to determine whether they are leases or contain a lease. A lease contract is defined as a contract, or part of a contract, that conveys the right to control the use of an asset for a time period in exchange for consideration. A lease exists if the right to control the use of property, plant, or equipment has been transferred, and that includes determining whether “the right to obtain substantially all of the economic benefits from use of the identified asset” and “the right to direct the use of the identified asset” have been transferred to the customer (see Accounting Standards Classification (ASC) 842-10-15-3 and 15-4).

## Lessees

Most leases today are operating leases and are accounted for off-balance sheet by lessees. In a significant change under the new leases standard, these leases – except for short-term leases that are subject to an accounting policy election – will be accounted for on the lessees' balance sheets. An asset will be recorded to represent the right to use the lease asset, and a liability will be recorded to represent the obligation arising from lease contracts.

Lessees will be permitted to make an accounting policy election to not recognize lease assets and liabilities for short-term leases<sup>2</sup> (that is, lease terms<sup>3</sup> that are 12 months or less, subject to certain conditions contained in the definitions of "short-term lease" and "lease term"). The lease term will include periods subject to an option to extend the lease if the lessee is reasonably certain to exercise that option. Leases of 12 months or less with extension options that meet that criteria will come onto the balance sheet. Furthermore, options to extend a lease should be added to the lease term only if it is "reasonably certain" that the lessee will exercise the option. The FASB has indicated that "reasonably certain" is a high threshold, which is consistent with, and intended to be applied in the same way as, the "reasonably assured" threshold in existing lease guidance. A lessee should reassess the lease term if a significant event occurs or a significant change in circumstances within the lessee's control occurs. Lessors are not required to reassess the lease term.

Under the new standard, a lessee will account for most existing capital leases as finance leases (that is, amortization of the ROU asset will be recognized separately from interest on the lease liability), and many existing operating leases will remain operating leases (that is, a single total lease expense will be recognized). Finance leases will reflect a front-loading of expense in the income statement, while operating leases will reflect a straight-line recognition of expense. Both finance and operating leases will result in the lessee's recognition of an ROU asset and a lease liability.

**Lease Classification.** Under the new standard, after determining that a contract contains a lease, a lessee will need to evaluate whether the lease is finance or operating at the commencement of a new lease and upon a change in the lease term or a change in the lessee's option to purchase the asset. A lessee will not apply a bright-line test to determine the classification of a lease as finance versus operating. Rather, a lessee will evaluate whether it has met any of five criteria listed in the new standard, which are based on whether the lessee obtains control of the underlying lease asset rather than control over merely the use of the underlying lease asset. If it has met any of the criteria, the lease will be classified as a finance lease. In many cases, determining whether control of the underlying lease asset has been transferred will require significant judgment.

The new standard's five lease classification criteria (see ASC 842-10-25-2) are as follows:

1. "The lease transfers ownership of the underlying asset to the lessee by the end of the lease term."
2. "The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise."
3. "The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease."
4. "The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or 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."

If none of these criteria are met, the lessee will classify the lease as an operating lease.

### **"Lease-ons" Learned**

Leases that provide for variable lease payments may include only payments that depend on an index or rate in the initial measurement of the lease asset and lease liability. The index or rate used in the initial measurement will be required to be the index or rate at lease commencement.

### **"Lease-ons" Learned**

Long-lived asset impairment testing (under ASC 360-10-35) will need to be performed for ROU assets recorded for both of the lease types. Any variable lease payments excluded from the lease liability for both lease types shall be expensed in the period incurred.

**Measurement.** When a lessee establishes an ROU (or lease) asset and lease liability on the balance sheet, the lease liability shall be measured initially at the present value of the lease payments for both finance and operating leases, and the ROU asset shall be measured initially as the lease liability amount, adjusted for lease incentives received, initial direct costs incurred, and any lease payments made before or at commencement (see ASC 842-20-30-1 and 30-5).

For a finance lease, the lessee will recognize amortization of the ROU asset on a straight-line or other systematic basis and interest on the lease liability using the effective interest method (that is, based on a constant periodic discount rate). For an operating lease, a single lease expense will be recognized, and it will include total lease payments and total initial direct costs over the lease term on a straight-line or other systematic basis.

Lessees will also subsequently measure the lease liability for operating leases at the present value of the unpaid lease payments and the ROU asset at the lease liability amount adjusted for any impairment, lease prepayments or accruals, lease incentives balance, and unamortized initial direct cost (see ASC 842-20-35-3).

If a lessee makes the accounting policy election for short-term leases, as previously explained, leases with a lease term of 12 months or less will not require capitalization on the balance sheet, and lease payments will be expensed on a straight-line basis over the lease term, which is similar to current rules for an operating lease.

## Lessee Lease Classification and Presentation

	Finance Lease	Operating
Has control of the lease asset passed to the lessee?	<ul style="list-style-type: none"> <li>• Yes</li> </ul>	<ul style="list-style-type: none"> <li>• No</li> </ul>
Balance sheet	<ul style="list-style-type: none"> <li>• Right-of-use (ROU) asset</li> <li>• Lease liability</li> </ul>	<ul style="list-style-type: none"> <li>• ROU asset</li> <li>• Lease liability</li> </ul>
Income statement (characterization)	<ul style="list-style-type: none"> <li>• Interest expense</li> <li>• Amortization expense</li> <li>• Any impairment on ROU asset</li> <li>• Any variable payments if excluded from lease liability</li> </ul>	<ul style="list-style-type: none"> <li>• Lease expense (including initial direct costs)</li> <li>• Any impairment on ROU asset</li> <li>• Any variable payments if excluded from lease liability</li> </ul>
Pattern of expense	<ul style="list-style-type: none"> <li>• Front-loaded</li> </ul>	<ul style="list-style-type: none"> <li>• Straight-line, typically</li> </ul>
Cash flow statement	<ul style="list-style-type: none"> <li>• Operating – cash paid for interest and variable and short-term lease payments excluded from lease liability</li> <li>• Financing – cash paid for principal</li> </ul>	<ul style="list-style-type: none"> <li>• Operating – cash paid for lease payments</li> </ul>

### Lessors

Lessor accounting for sales-type, direct-finance, and operating leases under existing GAAP and the new standard are similar but with a few differences. Following are some of the more significant differences for lessors.

**Lease Classification.** After determining that a contract contains a lease, a lessor will determine the lease classification: sales-type, direct-finance, or operating.

A lessor will first determine whether a lease should be classified as sales-type by applying the same five criteria that lessees use (listed under “Lease Classification” in the foregoing “Lessees” section), and if any are met (that is, if the lessee effectively obtains control of the lease asset), the lease will be classified as a sales-type lease.

### “Lease-ons” Learned

Under the new leases standard, lessees and lessors will account for related-party leases on the basis of legally enforceable terms and conditions stated in the lease. This differs from existing U.S. GAAP, which requires lessees and lessors to account for related-party leases on the basis of the leases’ economic substance, which can be difficult to establish.



## “Lease-ons” Learned

Leveraged lease accounting is eliminated under the new leases standard. Leases that currently qualify as leveraged leases will be evaluated for classification as direct-finance or operating leases, which is consistent with the treatment of all other leases under the new standard. Existing leveraged leases will be grandfathered during transition.

If the lease does not meet any of the initial five criteria, a lessor will determine if the lease meets the two criteria that trigger classification as a direct-finance lease. Those two criteria are: 1) the present value of the sum of the lease payments and any additional guaranteed residual value equals or exceeds substantially all of the fair value of the lease asset, and 2) it is probable that the lessor will collect the lease payments and any guaranteed residual value (see ASC 842-10-25-3(b)).

Leases that do not meet any of the initial five criteria to be classified as sales-type leases and that do not meet both criteria to be classified as direct-finance leases will be classified as operating leases.

**Measurement.** For leases that qualify as sales-type leases, the lessor will remove the existing lease asset from the balance sheet and record the net investment in the lease. However, if collectability is not probable, the lease asset will not qualify for derecognition, and the lease asset shall continue to be reflected on the lessor’s balance sheet. This criterion was put in place to create consistencies between the lessor’s income recognition model and the new revenue recognition standard, ASU No. 2014-09, “[Revenue From Contracts With Customers \(Topic 606\)](#).”<sup>34</sup> The FASB decided that a lessor will be precluded from recognizing selling profit and revenue for any lease that does not transfer control of the underlying asset to the lessee. This requirement aligns the notion of what constitutes a sale in the lessor accounting guidance with the concept in the new revenue recognition standard of evaluating, from the customer’s perspective, whether a sale has occurred.

For direct-finance leases, the lessor will remove the existing lease asset from the balance sheet and record the net investment in the lease. Because a direct-finance lease does not transfer control of the underlying asset to the lessee, only the selling loss arising from the lease, if applicable, shall be recognized.

For both sales-type leases and direct-finance leases, the lessor will recognize interest income on the net investment in the lease using the effective interest method (that is, based on a constant periodic discount rate). Variable lease payments that are not part of the net investment in the lease are recognized into income in the period in which the changes in facts and circumstances on which the variable lease payments are based occur.

Under the new standard, operating leases will be treated similarly to their treatment under existing guidance. The lessor will retain the underlying asset and recognize lease payments into income over the lease term on a straight-line or other systematic basis. Variable lease payments will be recognized into income in the period in which the changes in facts and circumstances on which the variable lease payments are based occur. Initial direct costs will be deferred at the lease commencement date and amortized to expense over the lease term on the same basis as lease income.

### Lessor Lease Classification and Presentation

	Direct-Finance or Sales-Type Lease	Operating Lease
Has control of the lease asset passed to the lessee?	<ul style="list-style-type: none"> <li>• Direct-finance – no</li> <li>• Sales-type – yes</li> </ul>	<ul style="list-style-type: none"> <li>• No</li> </ul>
Does the present value of the sum of the lease payments and any residual value guarantee equal or exceed substantially all of the fair value of the leased asset?	<ul style="list-style-type: none"> <li>• Direct Finance – yes</li> </ul>	<ul style="list-style-type: none"> <li>• No</li> </ul>
Balance sheet	<ul style="list-style-type: none"> <li>• Net investment in the lease (unless, for sales-type lease, collectability is not probable, and the lease asset is not derecognized)</li> </ul>	<ul style="list-style-type: none"> <li>• Continue to recognize underlying asset</li> </ul>
income statement	<ul style="list-style-type: none"> <li>• Direct-finance – interest and profit over lease term, loss at commencement</li> <li>• Sales-type – interest over lease term, profit/loss at commencement if collectability is probable</li> </ul>	<ul style="list-style-type: none"> <li>• Lease income, typically straight-line</li> </ul>
Cash flow statement	<ul style="list-style-type: none"> <li>• Operating–cashreceived for lease payments</li> </ul>	<ul style="list-style-type: none"> <li>• Operating–cashreceived for lease payments</li> </ul>



---

## Sale and Leaseback Transactions

The new leases standard requires parties to a sale and leaseback transaction to assess whether the sale of the property in question meets the criteria for a sale in the new revenue recognition standard, which focuses on elements of control. Because usually an operating lease conveys a right to control the use of an asset for the lease period, and does not transfer control of the asset itself to the lessee, the existence of the leaseback will not prevent the buyer-lessor from obtaining control of the asset.

The new standard also establishes that if the buyer-lessor in a sale and leaseback transaction determines that the leaseback should be classified as a sales-type or direct-finance lease, then no sale has occurred because control has not transferred to the buyer-lessor (see ASC 842-40-25-2). In that case, the buyer-lessor would not account for a purchase of the asset, and the seller-lessee would not account for a sale. In addition, repurchase options contained in a leaseback would preclude sale treatment – unless the repurchase option is exercisable only at the then-prevailing fair value and the lease asset is not specialized (see ASC 842-40-25-3).

Given the changes to sale and leaseback transactions under the new leases standard, the FASB has provided implementation guidance that addresses whether a sale has occurred in the context of a sale and leaseback transaction (see ASC 842-40-55).

In general, accounting by both parties – the buyer-lessor and the seller-lessee – will be consistent with the accounting for the purchase and sale of any other similar nonfinancial asset, and the leaseback will be consistent with that of any other lease. However, the standard does address sale and leaseback transactions entered into at off-market terms for which there is a difference between either 1) the sale price and the fair value of the underlying asset or 2) the present value of the contractual lease payments and the present value of market value lease payments, whichever is more readily determinable. For such off-market transactions, any deficiency will be accounted for in the same manner as a prepayment of rent, while any excess will be accounted for as additional financing provided by the buyer-lessor to the seller-lessee (see ASC 842-40-30-1 and 30-2).

The transition guidance of the new standard contains a grandfathering provision that allows an entity to not reassess whether sale and leaseback transactions under existing GAAP would qualify as a sale and leaseback under the new leases standard as well.

Upon transition, the deferred gain or loss from sale and *capital* leasebacks by seller-lessees should continue to be amortized. The deferred gain or loss from sale and *operating* leasebacks by seller-lessees should be recognized as follows:

- To the extent the gain or loss did not result from off-market terms: a cumulative-effect adjustment at the later of the earliest comparative period presented (to equity) and the date of sale (to the income statement)
- To the extent the gain or loss resulted from off-market terms: an adjustment to the lease asset (if a deferred loss) or a financial liability (if a deferred gain) in the earliest comparative period presented

## Effective Dates

**Public business entities (PBEs) and certain not-for-profit entities and employee benefit plans:** Interim and annual periods beginning after Dec. 15, 2018, which applies to March 31, 2019, interim financial statements for calendar year-end entities.

**All other entities:** Annual periods beginning after Dec. 15, 2019, and interim periods within the fiscal years beginning after Dec. 15, 2020, which applies to Dec. 31, 2020, annual financial statements for calendar year-end entities.

**All entities:** Early adoption is permitted for all entities.

## Transition

ASU 2016-02 provides a framework for applying the new rule changes to lessees and lessors.

Lessees will apply a modified retrospective transition approach for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements.

Lessors will apply a modified retrospective transition for sales-type, direct financing, and operating leases existing at, or entered into after, the date of initial application.

Under the modified retrospective transition, the earliest historical periods presented will need to be revised, but leases that expire prior to the beginning of the earliest comparative period presented will not require assessment under the new standard.

Finally, practical expedients for transition have been provided, including the option to make an accounting policy election that provides relief from reassessing the existence and classification of leases in contracts that existed or expired before the effective date. If the accounting policy is elected for such existing and expired leases, the transition to the new leases standard will generally be limited to leases entered into after the effective date (see ASC 842-10-65-1(k) through 65-1(m)).

### “Lease-ons” Learned

When planning their implementation timing for the new standards, organizations likely will need to consider the implementation efforts of other recently issued and far-reaching accounting standards, such as ASC Topic 606, “Revenue From Contracts With Customers.” Organizations without a high volume of leases or complex leasing arrangements may find it advantageous to adopt the new leases standard early, in order to avoid resource constraints from other accounting standard implementation projects. Serious consideration should be given to the practical expedients provided for transition, because they can often limit the impact on adoption to modified leases and operating leases of lessees for the periods presented.

---

## Required Disclosures

In the new standard, the FASB established detailed quantitative and qualitative disclosure requirements to “enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.” Following is an overview of the disclosures that will be required.

### Lessees

Lessees will be required to disclose qualitative information about the nature of their leases, including:

- A general description of the organization’s leases
- Significant terms, including options to extend or terminate a lease
- Residual value guarantees
- Any additional restrictions or covenants imposed under a lease

Other required disclosures include:

- Information about leases that have not yet commenced but create significant risks and obligations for the entity
- Significant assumptions and judgments made in applying the leases standard
- Whether the entity made an accounting policy election for the short-term lease exemption

Lessees will be required to either present as separate line items on the balance sheet or separately disclose in the notes the ROU assets and lease liabilities relating to finance leases and operating leases. If disclosing only in the notes, an organization will also need to disclose which line on the balance sheet includes the ROU assets and lease liabilities.

The standard specifies several required quantitative disclosures related to the total lease cost from leasing transactions, including the following:

- Finance lease expense – Amounts of amortization expense and interest expense. These amounts are not required to be presented as separate line items, but they should be presented consistent with the organization’s presentation policy for interest expense and amortization of similar assets.
- Operating lease expense – This amount is to be included in income from continuing operations in the income statement.
- Short-term lease expense
- Variable lease expense
- Sublease income
- Gains or losses on sale and leaseback transactions
- Cash paid – Segregated as follows:
  - Finance leases – operating cash flows (interest) and financing cash flows (principal repayments of the lease liability)
  - Operating leases – lease payments reflected in operating cash flows

- Supplemental noncash information for lease liabilities relating to additions of ROU assets – separately for finance leases and operating leases
- Weighted-average remaining lease term – separately for finance leases and operating leases
- Weighted-average discount rate – separately for finance and operating leases
- Aggregate undiscounted lease payments for the first five years after the reporting date and the remaining portion thereafter, with a reconciliation of the undiscounted maturities to the lease liabilities presented on the balance sheet or disclosed in the notes

Additional disclosures are required for sale-leaseback transactions.

## Lessors

Following are some of the qualitative disclosures that will be required of lessors:

- A general description of the organization's leases, including significant terms of the leases
- Description of significant assumptions and judgments made when applying the leases standard
- The entity's consideration of risk related to the residual value of its lease assets (including any residual value guarantee)
- Lessors will also be required to provide the following quantitative information about leasing activities:
  - Required property, plant, and equipment (PP&E) disclosures for assets subject to operating leases, separately from other PP&E
  - Table of lease income during the reporting period
  - For sales-type and direct-financing leases, the aggregate undiscounted cash flows for the first five years subsequent to the reporting date and remaining portion thereafter, with a reconciliation of the undiscounted maturities to the amounts recorded on the balance sheet
  - For operating leases, the aggregate undiscounted cash flows for the first five years subsequent to the reporting date and the remaining portion thereafter
  - The components of the lessor's net investment in sales-type and direct-finance leases, such as:
    - Lease receivables
    - Unguaranteed residual assets
    - Any deferred selling profit on direct-finance leases

Existing disclosure requirements for related-party transactions apply to both lessees and lessors (see ASC 850-10-50).

## “Lease-ons” Learned

Although U.S. GAAP does not require it, financial statement preparers should consider presenting the quantitative lessee disclosures in a tabular format to reflect the transparency goal of the new leases standard. Quantitative lessor disclosures require a table of lease income. Stakeholders may also find that tabular presentation of other required quantitative disclosures provides a straightforward view of the entity's lessor activities.

---

## Considerations for Nonpublic Business Entities

For nonpublic business entities, the new leases standard provides a practical expedient with respect to lessees when a lease liability is being measured. In measuring the lease liability for all leases, a nonpublic business entity may elect an accounting policy to use a risk-free discount rate that is determined using a period comparable to the remaining lease term (see ASC 842-20-30-2).

## Implementation Considerations

Organizations that engage in leasing should begin planning now for the implementation of the new standard. Because of the modified retrospective transition requirements, organizations with significant leasing activity might need to have dual reporting capabilities in place before the required implementation date, so that comparative information is readily available at the time of implementation.

Organizations with significant leasing activity should consider taking the following actions now:

- **Form an implementation task force.** Responding to the impact of the new leasing guidance and the need to collect related information for recognition and disclosure is likely to require the efforts of a cross-functional team. Various departments – including accounting, finance, operations, logistics, legal, tax, and IT – should be represented on the task force.
- **Understand and evaluate the transition.** Determine the adoption date for the organization (given that early adoption is allowed) and whether the practical expedients related to transition will be elected. Applying these practical expedients is likely to reduce the amount of work required to implement the new standard.
- **Evaluate existing leases.** Whether practical expedients are elected or not, lessees must assess the operating leases that exist in the periods that will be presented upon adoption of the standard, because recognition of those leases on the balance sheet will be required. In addition, for the periods to be presented, the implementation team should understand all lease modifications and how they will fit into the new lease model.
- If practical expedients are not elected, the team should understand before the effective date how the structure of the organization's current leases fits into the new lease model. Many contracts existing in the periods presented will need to be assessed to determine whether they contain lease agreements. For contracts that contain leases, the organization will need to determine the lease classification and assess the lease term. (As previously explained, if operating leases are subject to the short-term lease policy election, lessees will not have to recognize the lease asset and liability on the balance sheet.)

- **Assess the impact.** The team should perform an assessment of the financial impact of accounting for its current leases under the new model. Again, if the practical expedients are elected for transition, the primary impact will relate to lessees' operating leases and leases modified in the periods presented upon adoption. Those performing this exercise should consider other ramifications of applying the new leases standard beyond the organization's financial statements, such as the impact on key financial ratios included in debt covenants or key performance indicators used to manage the business.
- **Begin documenting significant judgments.** The team should analyze and document significant judgments as well as the estimates and other factors that contributed to those judgments. These include:
  - Whether a lease exists in a contract
  - Whether control of the lease asset has transferred
  - The lease term
  - Discount rates
  - Variable lease payments
  - Guaranteed residual values
- **Consider possible changes to systems, process, and controls.** The new leasing guidance may require an organization to gather more or different information about its lease activity than it has in the past. Information systems and databases may require revision to incorporate additional fields or different information. More sources of information and other data requirements could require changes in the personnel and procedures involved in key accounting processes. As a result, organizations may need to adopt new internal controls or modify existing controls to help ensure that the information to be used when applying the new standard is complete and accurate.
- **Consider the impact on financial and business practices.** The new leases standard's requirements could dramatically affect an organization's balance sheet and other key performance indicators, such as financial ratios. The team should identify the financial statement users and the aspects of the business that could be affected when the new standard is implemented. The team should also explore the potential impact on areas such as debt covenants, access to additional financing, capital spending, internal and external financial analyses, bonus and incentive plans, cash flow strategies, and contracting and pricing practices.
- **Consider the tax implications.** Changes in the timing and amount of expense recognition could affect the organization's income tax reporting and could result in larger or smaller book-versus-tax timing differences. The result could be changes in the timing of tax payments and changes in the organization's deferred tax assets and liabilities. The organization's tax preparers will need to understand the impact of the new rules on book and tax accounting methods as well as any resulting changes in the lease information accumulated by the organization for tax recordkeeping purposes.





### **Be Prepared**

The new leases standard contains some dramatic changes. Because almost all organizations have a lease contract for something, financial and operating executives should start exploring now, before the standard goes into effect, how their financial statements will be affected and the changes their organizations should make as a result.



## Learn More

Scott Lehman  
Partner  
+1 630 574 1605  
[scott.lehman@crowe.com](mailto:scott.lehman@crowe.com)

David Wentzel  
Principal  
+1 630 575 4300  
[david.wentzel@crowe.com](mailto:david.wentzel@crowe.com)

*Staci Shannon contributed to this article.*

---

<sup>1</sup> ASU 2016-02 comprises three sections: Section A – [“Leases: Amendments to the FASB Accounting Standards Codification”](#); Section B – [“Conforming Amendments Related to Leases: Amendments to the FASB Accounting Standards Codification”](#); and Section C – [“Background Information and Basis for Conclusions.”](#)

<sup>2</sup> “Short-term lease” is defined in ASU 2016-02 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.”

<sup>3</sup> “Lease term” is defined in ASU 2016-02 as “The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following: a) Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; b) Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option; and c) Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor.”

<sup>4</sup> See the Crowe [Revenue Recognition Resource Center](#).