Navigating the New Lease Accounting Standards - An Overview for Not-for-Profits

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, Leases (Topic 842). Spanning nearly 500 pages, the standard has far-reaching implications and is divided into 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 (ASC); and
- Section C – Background Information and Basis for Conclusions.

The ASU on leases will take effect for public companies (including not-for-profit organizations that are conduit bond obligors or that have other publicly traded debt) for fiscal years and interim periods within those fiscal years, beginning after December 15, 2018. For all other organizations, the ASU on leases will take effect for fiscal years beginning after December 15, 2019 and for interim periods within fiscal years beginning after December 15, 2020. Early application is permitted for all organizations.

Why a New Standard?

The ASU affects all organizations and is the culmination of more than ten years of collaboration between FASB and International Accounting Standards Board (IASB), nearly 1,700 comment letters, more than 200 meetings with preparers, and 5 public roundtables with more than 180 representatives and organizations. Additionally, the organizations hosted 15 preparer workshops attended by representatives from more than 90 organizations, 14 meetings with preparers, and individual meetings with more than 500 users of financial statements from a broad range of industries.

FASB identified the following improvements they seek to achieve through issuing the new lease standards:

- More faithful representation of a lessee's rights and obligations arising from leases
- Fewer opportunities for organizations to structure leasing transactions to achieve a particular outcome on the balance sheet
- Improvements in the understanding and comparability of a lessee's financial statements
- Alignment of lessor accounting and sale and leaseback transactions with comparable revenue guidance in the 2014 revenue recognition standard
- Additional information about lessors' leasing activities and exposure to credit and asset risk as a result of leasing
- Clarification of the definition of a lease to address practice issues within current GAAP such as the concept of control, used predominantly in standards with respect to revenue recognition and consolidations

Key Requirements

- **Lessees Will Recognize Most Leases on the Statement of Financial Position:** With the exception of leases that have a term of 12 months or less, all leases will be recognized on the balance sheet. This will be accomplished by recording both a right of use (ROU) asset and lease liability. Executory costs should also be considered in this analysis and recorded based on the specifics of the lease terms or donor agreement.

- **Donated Rent and Below-Market Leases:** When calculating ROU assets and lease liabilities, organizations should not include the market value of donated use of facilities. (Consideration, as defined in the accounting guidance, should only include cash or other assets exchanged in the transaction.) Any donated rent, meaning the difference between the value of assets given to the lessor and market rent, should be recorded as a contribution. The contribution receivable may be described in the financial statements based on the item whose use is being contributed, such as a building, rather than as contributions receivable, as discussed in FASB ASC 958-605-55-24.

- **Fewer Lease Origination Costs Will Be Capitalized:** The definition of initial direct costs has narrowed under the new standard to include only incremental costs incurred because of executing the lease. Origination costs that were historically capitalized under existing guidance, including costs to negotiate and arrange a lease, will now be expended when incurred.

- **Expanded Quantitative and Qualitative Disclosures:** The new standard requires expanded quantitative and qualitative disclosures by both lessees and lessors. Examples are provided in FASB's authoritative guidance.

- **New Judgments Are Required to Identify a Lease:** Although the new definition of a lease is similar to that under current GAAP, some arrangements that currently contain a lease will no longer meet the criteria under the new definition. A new requirement to determine whether the customer has the right to direct the use of the identified asset will entail significant judgment.

- **Significant Judgment Still Exists in Recording Leases on the Statement of Financial Position:** Lease accounting will continue to require significant judgments by management, including when organizations establish estimates related to the lease term, lease payments and discount rate. Non-public entities have an accounting policy election to use a risk-free interest rate to determine the present value of the lease payments. Similar to the current standard, the term of the lease will include the non-cancellable lease term plus renewal periods that are reasonably certain of exercise by the lessee or within the control of the lessor.

- **Embedded Leases:** If property, plant, or equipment is explicitly or implicitly identified and its use is controlled by the customer in a contract, an embedded lease exists. This differs from today's risks and rewards model and may result in fewer embedded leases being identified under the new lease standard.

- **Lessee Reassessments:** In certain circumstances, the lessee is required to remeasure the lease payments. Remeasurement of the lease payment may be triggered by a reassessment of the lease term (should conditions change from the initial measurement), even if there is not a lease modification.

- **Accounting for Fixed Executory Costs:** Fixed payments by the lessee to cover lessor costs related to ownership of the underlying asset such as property taxes or insurance (also referred to as executory costs), that do not represent payments for a good or service will be considered lease payments and reflected in the measurement of ROU assets and lease liabilities by lessees. Under current GAAP, payments for executory costs, including those to reimburse lessors for costs related to the underlying asset, are excluded from minimum lease payments and, therefore, from lease accounting.

- **Accounting for Variable Executory Costs:** Future variable payments such as taxes, insurance, and common area maintenance (CAM) are excluded from fixed payments in the measurement of lease assets and lease liabilities.

- **Lessor Accounting:** Lessor accounting remains largely unchanged, but has still been updated to align with certain changes to the lessee model. Leveraged lease accounting has been eliminated, although existing arrangements will be grandfathered.

- **Collectability Considerations and Variable Payments:** When collectability of lease payments are uncertain (for example, if the lessee's ability and intention to pay is in doubt, and it is uncertain whether the lessor will collect the lease payments and any amount necessary to satisfy the residual value guarantee provided by lessee), lessors may now have to recognize some lease payments as liabilities, which is a change to existing guidance. Other leases that have significant variable payments will no longer be classified as operating leases solely due to the extent of variable payments. This may result in a negative implicit rate for the lease or loss recognition at lease commencement.

- **Build-to-Suit Arrangements:** Fewer build-to-suit lease activities will be subject to sale-leaseback accounting requirements under the new standard. This is due to the process for determining when a lessee controls an underlying asset before lease commencement and will result in fewer transactions where the lessee is considered the owner of an asset for accounting purposes during the construction period than under current GAAP. Changes made to sale-leaseback guidance also make it easier for lessees to remove real estate assets recognized during the construction period from their balance sheets. The transition provisions of the new standard will permit many entities to de-recognize build-to-suit assets and liabilities that have remained on the balance sheet after the end of the construction period under existing GAAP.

Implementation Considerations

The final standard can be summarized as moving operating lease obligations from the footnotes to the statement of financial position. Bringing operating leases onto the entity's statement of financial position could make a significant difference in the numbers a company is reporting. Many lessees will be able to meet the new reporting and disclosure requirements by leveraging existing systems and processes.

Although initial implementation will require some level of effort, the ongoing costs of providing the information are expected to be consistent with the costs of complying with existing GAAP, according to FASB.

Here are some additional considerations:

- **Some organizations may need to spend significant resources to identify all leases and accumulate the data necessary to apply the new standard.** Some organizations keep lease records in electronic files on different hard drives or in multiple filing cabinets or spreadsheets. Ensuring that the inventory of leases is complete and accurate is one of the most important steps to implementing the new standard. Gaining a handle on all of the organization's leases, wherever records of those leases are kept, is necessary for compliance. Leases may be embedded in service arrangements or provided alongside other goods or services, so understanding where leases could exist within contracts or other agreements is critical. Once all leases are identified, each lease should be reviewed and evaluated to determine whether it should be classified as capital or operating.

- **Organizations should consider whether they have appropriate systems, processes, and internal controls to capture the required information.** The classification of each lease will affect how it is reported on the statement of activities and the statement of cash flows. To capture completely and accurately the lease data necessary to provide expanded qualitative and quantitative disclosures, some organizations may need to update or implement IT systems.

- **Transitioning to the new standard will have an impact on operations beyond just financial reporting.** Because of changes to the statement of financial position, transition may affect debt covenants, apportionment of income for state taxes (if applicable), and leases versus buy decision-making. Organizations should review existing contractual agreements, such as lending covenants, so that those can be adjusted as soon as possible once an accurate inventory of all leases has been obtained. Organizations should work with lenders through the normal course of business to amend debt agreements, if necessary, before the standard is adopted to avoid losing access to financing. This also may be a good time to look at lease procurement processes, which could reveal enhancements that could generate cost savings. If an organization has leases with multiple vendors, there may be an opportunity to consolidate and contract with just one vendor for a lower price.

Organizations are advised to have conversations with stakeholders early to ease the transition. Communicate the effects of anticipated changes in accounting for leases on the organization's financial statements to boards of directors, investors, lenders, donors, and other users of financial statements.

This Compliance Brief is designed as educational and reference material for the members of the AICPA's Not-for-Profit Section and others interested in the subject. It does not establish standards or preferred practices.

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