FASB Update on Lease Accounting

February 2017

FASB finalized guidance related to the new lease accounting standard. The following white paper provides information related to the guidance update and its impact on mortgage banking companies.

FASB Update of Lease Accounting

By: Chad Murphy, CPA – Audit Manager

Overview

After many years of debate, the FASB issued the Accounting Standards Update, Leases, (Topic 842) in order to increase transparency and comparability by recognizing leases as a lease asset and a lease liability on the balance sheet. Recognition of these lease assets and lease liabilities will allow users of the financial statements to have a complete and understandable picture of an entity's leasing activities. Since leases are currently treated as an off-balance sheet item, adoption of the new lease accounting standard will have a significant impact on accounting requirements and financial statement presentation.

The distinction between a finance lease (similar to capital leases) and operating lease will remain largely unchanged from previous lease accounting guidance, with the exception that operating lease assets and lease liabilities will now be recorded on the balance sheet. It is important that companies understand the differences between the new standard and previous guidance, as well as the impact of these changes on internal controls, loan covenant strategies, IT requirements, and third-party perception of a company's financial performance.

Who is required to record leases on the balance sheet?

All entities that enter into a lease will be required to recognize lease assets and lease liabilities on the balance sheet. However, for leases with a term of 12 months or less, a lessee will be allowed to make an accounting policy election to not recognize these assets and liabilities on the balance sheet.

Lessee Accounting

A lessee will recognize, on the balance sheet, the present value of lease payments as a lease liability and a right-of-use asset representing its right to use the underlying asset for the lease term. When measuring lease assets and liabilities, lessees should exclude optional period payments, such as a lease extension, unless it is reasonably certain that the option to extend the lease will be exercised.

A lessee will classify a lease as either a finance lease (similar to capital leases), operating lease, or sales-type lease. The recognition, measurement and presentation of expenses and cash flows arising from a lease have not significantly changed from the previous standard.

When recording financing leases (similar to capital leases), the following is required under the new standard:

1. Recognition of an asset and liability on the balance sheet, initially measured at the present value of the lease payments.
2. Interest expense on the lease liability will be recognized separately from the amortization of the asset.
3. Repayments of the principal portion of any lease liability will be classified as financing outflows, while payments of interest will be classified as operating outflows.

When recording operating leases, the following is required under the new standard:

1. Recognition of an asset and liability on the balance sheet, initially measured at the present value of the lease payments.
2. Recognition of a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a straight-line basis.
3. Classification of all cash payments within operating activities in the statement of cash flows.

A lessee will need to classify a lease as a finance lease when the lease meets any of the following conditions at the date of commencement:

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

If none of the above conditions is met, the lessee will classify the lease as an operating lease or a direct financing lease.

Lessor Accounting

Lessor accounting will remain largely unchanged under the new standard. Operating leases should remain classified as operating leases, and lessors should continue to recognize lease income on a straight-line basis over the lease term.

Effective date

The FASB is allowing ample time to implement the standard, which will go into effect for fiscal years beginning after December 15, 2019 for privately held enterprises. Companies will be required to apply the changes using a modified retrospective adjustment to the statement of financial position as of the beginning of the earliest period presented. Early application is permitted for all entities.

How can you prepare now?

We recommend companies begin evaluating their internal controls to determine the impact and resources needed to successfully implement the new lease accounting standard. Richey May & Co. will continue to monitor and provide guidance on the new lease accounting standard in an effort to facilitate a smooth transition for mortgage lending entities.