



# FASB ISSUES NEW LEASE ACCOUNTING GUIDANCE

## CONSUMER FINANCE

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### About Navigant

Navigant Consulting, Inc. (NYSE: NCI) is a specialized, global professional services firm that helps clients take control of their future. Navigant's professionals apply deep industry knowledge, substantive technical expertise, and an enterprising approach to help clients build, manage and/or protect their business interests. With a focus on markets and clients facing transformational change and significant regulatory or legal pressures, the Firm primarily serves clients in the healthcare, energy and financial services industries. Across a range of advisory, consulting, outsourcing, and technology/analytics services, Navigant's practitioners bring sharp insight that pinpoints opportunities and delivers powerful results. More information about Navigant can be found at [navigant.com](http://navigant.com).

## INTRODUCTION

On February 25, 2016, the Financial Accounting Standards Board (FASB) finally issued Accounting Standards Update (ASU) 2016-02, Leases. This long-awaited guidance, which had been under development for almost ten years, incorporates feedback on two exposure drafts from 2010 and 2013, and is listed as Topic 842 within the Accounting Standards Codification (ASC). The FASB issued ASC 842 in response to a growing need by stakeholders for transparency into previously off-balance sheet leasing obligations, which are estimated to be over \$1.25 trillion in aggregate. The guidance supersedes ASC 840 – Leases. ASC 842 is not fully convergent with International Accounting Standard (IAS) 17 – Leases.

The most material difference between the new ASC 842 and current practice is the gross-up of an entity's balance sheet to recognize an asset and liability for operating leases. ASC 842 defines leases as either *Finance* or *Operating*, as opposed to *Capital* or *Operating* under ASC 840. As stakeholder feedback mainly focused on lessee accounting, lessor accounting has remained largely unchanged.

## LESSEE ACCOUNTING

Lessees must now recognize assets and liabilities associated with all leasing contracts under the following model:

### For Finance Leases, the Lessee will:

- Recognize a "Right of Use" asset and corresponding "Lease Liability" on the Statement of Financial Position, measured at the present value of expected lease payments.
- Recognize interest expense resulting from the amortization of the "Lease Liability" separately from the amortization of the "Right of Use" asset on the Income Statement.
- Classify cash outflows related to interest expense within the Operating Activities of the Statement of Cash Flows, and outflows related to reduction of the "Lease Liability" within the Financing Activities.

### For Operating Leases, the Lessee will:

- Recognize a "Right of Use" asset and corresponding "Lease Liability" on the Statement of Financial Position, measured at the present value of expected lease payments.
- Recognize a single lease-related expense on the Income Statement, including both the interest expense on the amortization of the "Lease Liability", and straight-line amortization of the "Right of Use" asset.
- Classify cash outflows related to the lease within the Operating Activities of the Statement of Cash Flows.

Any optional payments or residual value guarantees will be incorporated into the asset and liability provided their probability of occurrence is *reasonably certain*.

## LESSOR ACCOUNTING

Lessor Accounting will remain largely unchanged from the previous guidance under ASC 840. Lessors will continue to recognize operating income and cash flows from Operating

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Leases, and will recognize an asset and liability in relation to Finance Leases.

### **For Finance Leases, the Lessor will:**

- De-recognize the underlying asset and recognize a corresponding “Lease Receivable” on the Statement of Financial Position, measured at the present value of expected lease payments.
- Recognize interest income resulting from the amortization of the “Lease Receivable” separately from the amortization of the contra-account on the underlying asset on the Income Statement.
- Classify lease-related cash inflows within the Operating Activities of the Statement of Cash Flows.

### **For Operating Leases, the Lessor will:**

- Continue to recognize the underlying asset on the balance sheet, with continued depreciation as necessary.
- Recognize lease income on the Income Statement.
- Classify cash inflows related to the lease within the Operating Activities of the Statement of Cash Flows.

## **OTHER CHANGES**

ASC 842 includes other changes, such as:

- Exemptions for short-term leases.
- New breakout criteria for non-lease contract components.
- Enhanced qualitative disclosures.
- Clarity on requirements for sale-leaseback treatment.

## **TRANSITION REQUIREMENTS**

ASC 842 will affect any entity engaging in lease transactions, and reporting its financial statements under U.S. Generally Accepted Accounting Principles. The guidance will come into effect on December 15, 2018 for public entities, and December 15, 2019 for non-public entities.

When making the transition to ASC 842, entities will be required to take a retrospective approach to adjusting their financial statements. In particular, lessees engaged in operating leases under previous guidance will be required to recognize the associated assets and liabilities on their balance sheets. These accounts should be measured at the present value of remaining lease payments on the contract.

## **KEY CONSIDERATIONS**

For many entities, transitioning to the new guidance will require substantial gross-ups of long-term assets and liabilities. This will have impacts on the presentation of the balance sheet, as well as

many of the financial metrics stakeholders use to evaluate entity performance. Companies should pay particular attention to their debt covenant ratios to ensure that the new standard does not trigger any non-compliance.

With the addition of a liability amortization component to Operating Lease Expenses, lessees will also experience a skewed distribution of lease expense toward the front of the lease term. As such, entities engaged in substantial operating lessee contracts can anticipate a decrease in short-term earnings versus prior forecasts, and a corresponding increase in long-term earnings. Entities should begin to pro-forma the impact of these changes.

Entities must be aware of the new guidance and make the necessary preparations to ensure a smooth transition, including:

- Develop and implement the necessary processes, systems, and controls to ensure proper accounting treatment of leases.
- Re-examine lease inventories across different business units, subsidiaries, and geographies, and determine the appropriate accounting treatment for each lease, including the measurement of the necessary retrospective balance sheet adjustments.
- Re-evaluate the entity's business rationale for leasing decisions to ensure that entity resources are fully optimized.
- Prepare stakeholders for the significant change in balance sheet presentation through the use of early disclosures and communications.

## **HOW NAVIGANT CAN HELP**

Navigant's professionals have deep leasing experience and the requisite knowledge and skills necessary to help clients implement complex accounting standards across multiple business units, legal entities, and geographies. Navigant is dedicated to assisting clients in achieving optimal results. Our experts have extensive experience working with clients as they revisit internal processes to modify or adjust how processes are conducted or data captured and reported according to new or expanded requirements. Navigant provides solutions for the most challenging aspects of this proposed guidance including:

- Performance of gap analysis of existing accounting policy and supporting operations to identify gaps to proposed guidance.
- Development of accounting policies and related financial statement disclosures.
- Design and development of future state of operations to ensure ongoing compliance with guidance.
- Analyze the downstream impact of new standards on other aspects of the business.