Deloitte.
Private

What private companies need to know about applying the new lease standard

In February 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-02, Leases (codified as Accounting Standards Codification Topic (ASC) 842). ASC 842 introduces a lessee model that brings most leases onto the balance sheet; aligns certain of the underlying principles of the lessor model with those in ASC 606, the FASB's new revenue recognition standard; and addresses other concerns related to the nearly 40-year-old leasing model from the previous guidance.

Key provisions of the new standard

Practitioners have estimated that $2 trillion[1] of lease liability (with corresponding recognition of leased assets) will be recorded to S&P 500 balance sheets alone as a result of the application of the new leasing guidance. What does the road ahead look like for a private company like yours?

This document highlights key considerations related to implementing the new leasing standard. See Deloitte's A Roadmap to Applying the New Leasing Standard (the "Leasing Roadmap") for further details.

Impact on lessee accounting

Lessees are likely to be most significantly affected by the new leasing standard. ASC 842 retains the two-model approach to classifying leases as operating or finance leases (formerly, capital leases); however, most leases, regardless of classification type, are recorded on the balance sheet. A lessee may elect, as an accounting policy, not to record leases with terms of 12 months or less on the balance sheet.

When a lessee records a lease on the balance sheet, it will recognize a lease liability based on the present value of the future lease payments, with an offsetting entry to recognize a right-of-use (ROU) asset. A lessee will use a discount rate to determine the present value based on the rate implicit in the lease, if readily determinable, or the lessee's incremental borrowing rate.

Although both operating and finance leases will be recorded on the balance sheet, the expense recognition pattern will differ for each. For an operating lease, a lessee would recognize lease expense on a straight-line basis over the lease term. For a finance lease, the lessee would recognize both interest expense (by using the effective interest method) and amortization expense. Therefore, the lessee would generally recognize greater expense earlier in the life of the lease for a finance lease than for an operating lease.

Impact on lessor accounting

Although the changes to the lessor model are not as significant as those to the lessee model, lessors should not underestimate the ASU's potential effect on their financial statements and disclosures. Most importantly, the profit

[1]Source: Coming to a Balance Sheet Near You: $2 Trillion in Leases, *The Wall Street Journal*, November 2015

recognition requirements under the lessor model are aligned with those under the FASB's new revenue recognition requirements, and the lease classification criteria have been amended to be consistent with those for a lessee. The ASU requires a lessor to classify a lease, at its commencement, as a sales-type lease, direct financing lease, or operating lease on the basis of the classification criteria in the standard.

Disclosure requirements

The new standard also significantly expands the required lease disclosures. Entities should consider these disclosure requirements early in their implementation efforts to ensure that they are prepared.

Watch out! There were differences in the disclosure requirements for public and private companies under ASC 606, but not under ASC 842.

Disclosure requirements

Disclosure objectives

Enable financial statement users to assess the amount, timing, and uncertainty of cash flows arising from leases

Lessee disclosures

- Nature of its leases
- Information about leases that have not yet commenced
- Related-party lease transactions
- Accounting policy election regarding short-term leases
- Finance and operating lease costs
- Short-term and variable lease costs
- Gain or loss from sale-and-leaseback
- Maturity analysis for lease obligations
- Weighted-average remaining lease term
- Weighted-average discount rate

Lessor disclosures

- Nature of its leases
- Significant assumptions and judgments used
- Related-party leases transactions
- Tabular disclosure of lease-related income
- Components of the net investment in a lease
- Information on the management of risk associated with residual asset
- Maturity analysis of operating lease payments and lease receivable
- Information required by ASC 360

Definition of a lease

Under the new leasing standard, a contract is, or contains, a lease if the contract gives a customer the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. Control is considered to exist if the customer has both of the following:

01. The "right to obtain substantially all of the economic benefits from use of [an identified] asset."

02. The "right to direct the use of that asset."

Accordingly, the definition of a lease in the new leasing standard differs from that in existing U.S. GAAP. Under legacy accounting guidance, an entity is required to determine whether it has the "right to obtain substantially all of the economic benefits" from the use of that asset. Under the new standard, however, an entity must also determine whether it obtains the "right to direct the use" of the asset.

An entity is required at inception to identify whether a contract is, or contains, a lease. The entity will reassess its conclusion about whether the contract is or contains a lease only when the terms and conditions of the contract are modified.

Although the assessment of whether a contract is or contains a lease will often be straightforward, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset (i.e., an embedded lease).

Chapter 3 within the Leasing Roadmap contains a number of helpful examples to illustrate such assessments.

Components of a contract

ASC 842 requires entities to identify the lease and nonlease components of a contract that contains a lease. Although this requirement does not differ from that under existing U.S. GAAP, the effect of not applying this requirement correctly under ASC 842 is more significant because most leases must be recognized on the balance sheet under the new guidance.

A contract or lease agreement may contain multiple lease components. The right to use an underlying asset is considered a separate lease component if both of the following conditions are met:

01. **A lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available.**

02. **The underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement. Entities must also evaluate whether the right to use land and other assets should be accounted for separately. Accordingly, a contract may include multiple lease components for different underlying assets.**

When a contract includes both lease and nonlease components, an entity may be required to allocate the consideration in the contract to the various elements—for example, a real estate lease in which the lessee pays for both the use of the space (lease component) and common-area maintenance services (nonlease component). The consideration allocated to the lease component is accounted for under ASC 842, while the consideration allocated to the nonlease component is accounted for under other relevant GAAP (e.g., lessors would recognize revenue earned for common-area maintenance services in accordance with revenue guidance).

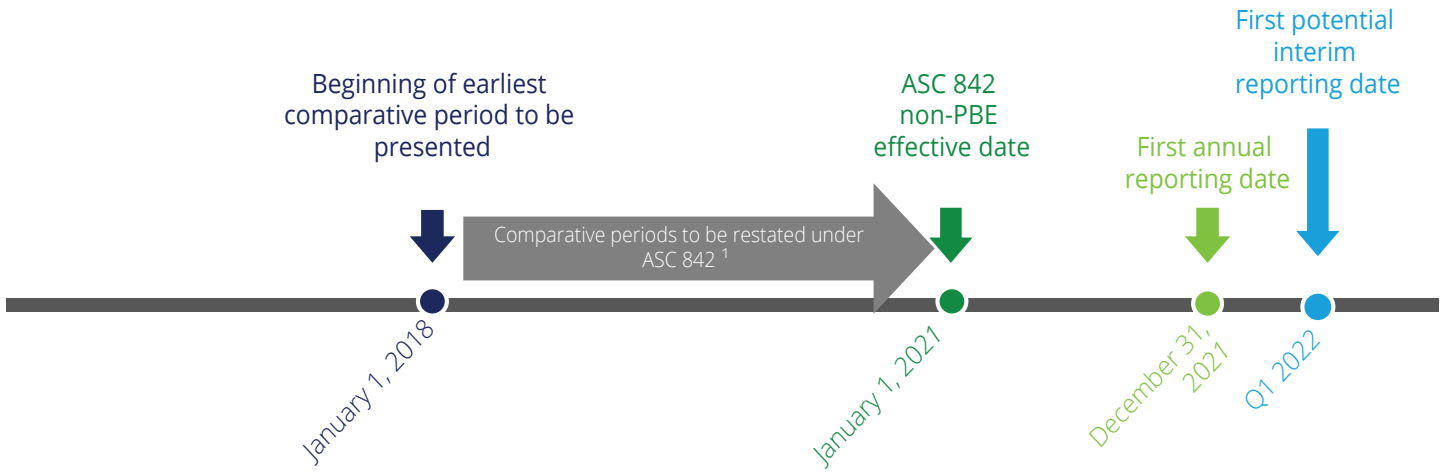
ASC 842 allows lessees to elect, as an accounting policy, not to separate lease and nonlease components. This would result in a larger lease liability on lessees' balance sheets.

Although such an election is currently not available to lessors, on January 5, 2018, the FASB issued a proposed ASU containing a practical expedient, under which lessors can elect not to separate lease and nonlease components if certain provisions are met. Further guidance will be provided pending the FASB's final decision on this proposed change.

Effective date and transition requirements for private companies

The new guidance is effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019) and interim periods therein. For all other entities, including **private companies**, the ASU is effective for annual periods beginning after December 15, 2020 (i.e., calendar periods beginning on January 1, 2021), and interim periods thereafter. Early adoption is permitted for all entities.

Illustrative timeline for a non-public business entity with a December 31 year-end



[1] On November 29, 2017, the FASB tentatively approved changes to ASC 842 that would allow the option to use the effective date of the new leases standard as their date of initial application in transition and not restate the comparative periods. This is subject to final approval by the Board after a public comment period, expected in early 2018. See Deloitte's December 5, 2017 Heads Up publication for additional information.

[2] For public business entities (and certain other entities), the effective date is for calendar periods beginning after December 15, 2018 and interim periods therein. For other nonpublic entities, the standard is effective for calendar periods beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Effective date and transition requirements for private companies (cont.)

An entity adopts ASC 842 by using a modified retrospective transition approach. Under this approach, the standard is effectively implemented as of the earliest period presented and through the comparative periods in the entity's financial statements. The modified nature of this transition approach is intended to maximize comparability while reducing the complexity of transition compared with the full retrospective approach, under which financial statements would be prepared as if ASC 842 were always effective. The January 5, 2018, proposed ASU allows entities to elect not to restate their comparative periods in transition. Accordingly, under the proposal, entities would be permitted to change their date of initial application to the beginning of the period of adoption; as a result, the presentation of comparative periods would be consistent with that in ASC 840.

The January 5, 2018, proposed ASU allows entities to elect not to restate their comparative periods in transition. Accordingly, under the proposal, entities would be permitted to change their date of initial application to the beginning of the period of adoption; as a result, the presentation of comparative periods would be consistent with that in ASC 840.

If the FASB finalizes the proposal and an entity elects the practical expedient described above, many companies may find transition easier. Although not final as of the date of this publication, because of the high likelihood that the ASU will be issued, we have referred the expedient as if it is available throughout Chapter 16 of the Leasing Roadmap.

[1] On November 29, 2017, the FASB tentatively approved changes to ASC 842 that would allow the option to use the effective date of the new leases standard as their date of initial application in transition and not restate the comparative periods. This is subject to final approval by the Board after a public comment period, expected in early 2018. See Deloitte's December 5, 2017 Heads Up publication for additional information.

[2] For public business entities (and certain other entities), the effective date is for calendar periods beginning after December 15, 2018 and interim periods therein. For other nonpublic entities, the standard is effective for calendar periods beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.

Did you know?

Did you know...
...the financial statement impact of failing to identify whether a contract is or contains a lease could be much more significant under the new leasing standard. As a result, many companies are "sharpening their pencils" on lease identification.

(Chapter 3 of the Leasing Roadmap)

Did you know...
...lessees may be required to remeasure the lease liability and ROU asset in certain circumstances. For example, remeasurement is likely to be required when there is a change in circumstances that leads to a change in the previous determination of whether the lessee is reasonably certain it will exercise a renewal option.

(Section 8.5 of the Leasing Roadmap)

Did you know...
...entities will most likely need to implement new, or change existing, business processes and internal controls to ensure compliance with the new guidance—for example, when applying judgment to aspects of the guidance such as lease term, reassessment events, and allocation of lease payments to lease and nonlease components on the basis of the relative stand-alone selling price.

(Appendix E of the Leasing Roadmap)

Did you know...
...contracts with a noncancelable term of less than 12 months might not qualify for the short-term lease exception if an entity is reasonably certain that renewal options will be exercised. "Lease term," as defined by ASC 842, includes renewal options whose exercise is reasonably certain. The short-term lease exception is available only if the lease term, which includes renewal options whose exercise is reasonably assured, is less than 12 months.

(Section 5.2 of the Leasing Roadmap)

Did you know?

Did you know...
...to comply with all of the new standard's requirements (including those related to disclosures), entities may need to implement new accounting software. Having a better understanding of existing lease contracts, including embedded leases, may help entities decide whether a technology or software solution is necessary.

(Appendix D of the Leasing Roadmap)

Did you know...
...certain third-party residual value guarantees will cause leases to qualify as direct financing leases under ASC 842 when they may have previously qualified as sales-type leases under ASC 840.

(Section 9.2 of the Leasing Roadmap)

Did you know...
...when a lessee determines the discount rate on the basis of its incremental borrowing rate (to measure the present value of the lease liability when the rate implicit in the lease is not readily determinable), the rate should be based on the lessee's collateralized borrowing rate for an instrument with a similar amount and similar term.

(Section 7.2 of the Leasing Roadmap)

Did you know...
...variable payments based on an index or rate are included in the measurement of a lease liability, which includes payments made on the basis of fair value. Although these types of variable payments are included in the lease liability at initial measurement, the lease would generally not be remeasured as the index or rate changes over the lease term.

(Section 6.3 of the Leasing Roadmap)

Did you know...
...some "failed" sale-leaseback transactions under legacy GAAP may achieve sale accounting under ASC 842. The requirements related to accounting for a transaction as a sale-leaseback are less cumbersome under the new guidance than under legacy GAAP. Generally, a sale-leaseback will qualify for such treatment if the seller-lessee transferred control of the underlying asset to the buyer-lessor.

(Chapter 10 of the Leasing Roadmap)

Deloitte Private

Deloitte Private delivers audit and assurance, tax, consulting, and risk and financial advisory services tailored for private companies, including family-owned businesses, closely-held (non-family) businesses, and private equity and venture-capital-backed businesses.

A distinctive client service experience

Tailored approach

Our team works to customize our service capabilities to each client's specific needs, size, and ownership structure. A single lead partner coordinates one team, comprising audit and assurance, tax, consulting, and risk and financial advisory professionals.

Technical abilities

The broad range of technical abilities among our professionals allows us to address complexity and find the right answer, often by simply "walking down the hall"—as opposed to starting from scratch.

Breadth and depth

Our collaborative approach brings the full breadth of our technical and industry capabilities, along with access to the resources of a global network. With more than 263,000 people worldwide, Deloitte member firms deliver services in more than 150 countries. As clients expand their global footprint, our scale helps efficiently meet their needs with local resources around the world.

Contacts

To learn more about how Deloitte can assist with your ASC 842 implementation activities, contact:

Jeanne McGovern
Partner
Deloitte & Touche LLP
+1 973 602 4105
jmcgovern@deloitte.com

Heather Gates
Managing Director
Deloitte & Touche LLP
+1 408 704 4414
hgates@deloitte.com

If you have questions about the information in this publication or the Leasing Roadmap, feel free to contact any of the following Deloitte professionals:

James Barker Partner
Deloitte & Touche LLP
+1 203 761 3550
jabarker@deloitte.com

Stephen McKinney Managing Director
Deloitte & Touche LLP
+1 203 761 3579
smckinney@deloitte.com

Joe DiLeo Managing Director
Deloitte & Touche LLP
+1 203 761 3195
jodileo@deloitte.com

Taylor Paul Senior Manager
Deloitte & Touche LLP
+1 203.423.4543
tapaul@deloitte.com

Nick Roger Partner
Deloitte & Touche LLP
+1 415.783.4915
nroger@deloitte.com

Brandon Coleman Partner
Deloitte & Touche LLP
+1 312 486 0259
brcoleman@deloitte.com

Kristin Bauer Partner
Deloitte & Touche LLP
+1 312 4 86 3877
kbauer@deloitte.com

Tim Kolber Senior Manager
Deloitte & Touche LLP
+1 203.563.2693
tkolber@deloitte.com

Bob Uhl Partner
Deloitte & Touche LLP
+1 203.761.3152
ruhl@deloitte.com

John Wilde Partner
Deloitte & Touche LLP
+1 415.783.6613
johnwilde@deloitte.com

Deloitte.
Private

To find out more, please visit **www.deloitte.com/us/ASC842guide**.