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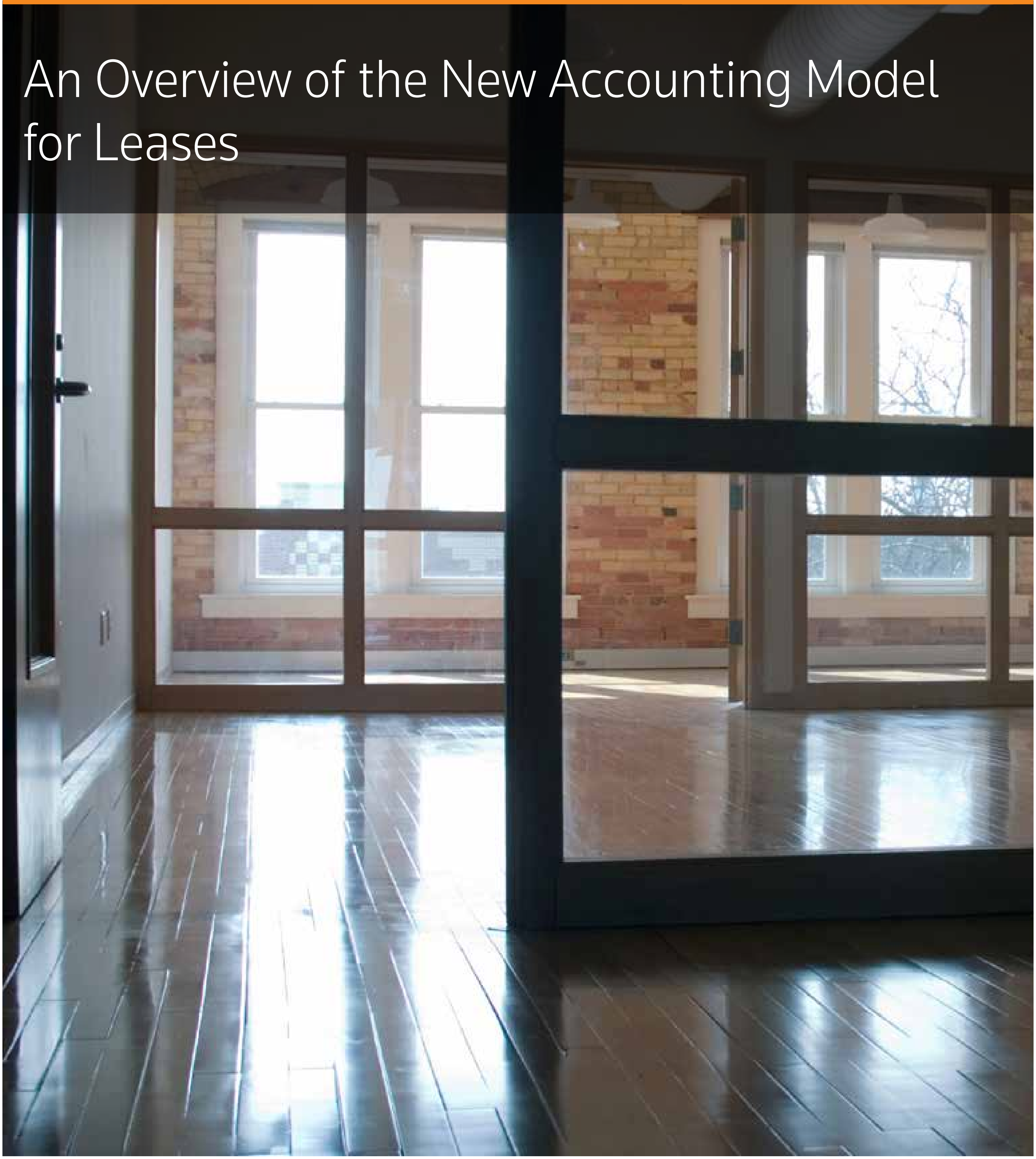
SPECIAL REPORT

An Overview of the New Accounting Model for Leases



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Leasing is an important source of financing for many entities in the United States and around the globe. Many entities enter into leasing arrangements to gain access to assets, obtain financing or reduce exposure to the risks of ownership of an asset. Yet, the current accounting model for leases, laid out in Topic 840, Leases, does not require lessees to recognize assets and liabilities arising from operating leases. Financial statement users have been very vocal and expressed concern about the current lease accounting model. The current model does not reflect the true economic substance of an operating lease transaction because it leaves a large financing resource off the balance sheet. Investors and analysts also requested better information about the risks lessors manage in relation to the residual value of their leased assets.

As a result of these concerns, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a joint project in 2006 intended to restructure the existing lease accounting guidance for both lessees and lessors under U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). This project aimed to increase transparency and comparability among organizations by requiring lease assets and lease liabilities to be recorded on the balance sheet and requiring key disclosures about these arrangements. Despite years of working together, the FASB and the IASB did not achieve full convergence on this project and issued distinct standards:

- In January 2016, the IASB issued its final standard, IFRS 16, Leases, which supersedes the guidance in IAS 17.
- In February 2016, the FASB issued Accounting Standards Update (ASU) No. 2016-02, Leases (Topic 842). This ASU supersedes the guidance in Topic 840 and introduces a new Topic 842, Leases. The new topic primarily addresses the criticisms of existing leasing guidance related to a lessee's accounting for operating leases. In particular, lessees will be required to recognize a right-of-use asset and a lease liability for all leases, including operating leases. Although lessor accounting is not fundamentally changed as a result of this ASU, some amendments have been made to conform the lessor guidance to the new revenue recognition model introduced in ASU No. 2014-09, Revenue Recognition from Contracts with Customers.

The current model does not reflect the true economic substance of an operating lease transaction — it leaves a large financing resource off the balance sheet.

WG&L OBSERVATION: The changes to lease accounting represent a significant change in lessee accounting for operating leases. With few exceptions, all leases must be capitalized, leading to significant effects on the reporting and documentation requirements of lessee preparers. Capitalization also is expected to affect key financial ratios, such as debt-to-equity and return on assets.

WG&L OBSERVATION: The standards issued by the FASB and the IASB are in agreement on certain major concepts. For instance, both standards require leases to be recognized on the balance sheet and use the same definition of a lease.

The standards, however, present important differences. Most notably, Topic 842 provides two classifications for lessees (operating and finance). IFRS 16 only provides one classification for lessees. Under IFRS 16, all leases will be accounted for by a lessee similar to the approach for finance leases under Topic 842.

Scope of the New Guidance on Leases

Topic 842 defines a lease as a contract that provides the right to control an identified asset (property, plant and equipment) for a period of time in exchange for consideration.

The scope of Topic 842 includes all leases and subleases, except for leases of:

- Intangible assets
- Biological assets
- Exploration or use of non-regenerative assets (e.g., oil and gas and minerals)
- Inventory
- Assets under construction

A lease can be a contract or a portion of a contract.

The scope of the lease guidance excludes non-lease components, such as service arrangements. As a practical expedient, though, a lessee may elect an accounting policy by class of underlying asset whereby it accounts for the lease component and the nonlease components of a contract as a single lease component.

Definition and Classification of a Lease

Revised Definition of a Lease

A contract is a lease if it provides the lessee with the right to control an identified asset for a period of time in exchange for consideration. An entity has control over the underlying asset if it has both:

Control

1. The right to obtain substantially all of the economic benefits from the use of the asset
2. The right to direct the use of the asset

WG&L OBSERVATION: The notion of control of the underlying asset was introduced in the definition of a lease by ASU No. 2016-02. While, in practice, this will not result in many changes in the characterization of a contract as a lease, there may be cases where a contract that is currently considered a lease under Topic 840 will not be deemed a lease under Topic 842.

WG&L OBSERVATION: The ability to control the underlying asset is what distinguishes a lease from a service contract.

In order to meet the definition of a lease, the contract must provide for the use of an explicitly or implicitly identified asset owned by another party. This asset must be physically distinct and the supplier of the asset cannot have substantive substitution rights.

A contract is a lease if it provides the lessee with the right to control an identified asset for a period of time in exchange for consideration.

Classification of a Lease

Under Topic 842, a lessee must distinguish between a finance lease and an operating lease in order to determine how to recognize the changes in lease assets and liabilities in the income statement. This classification is broadly similar to the distinctions between a capital lease and an operating lease in Topic 840.

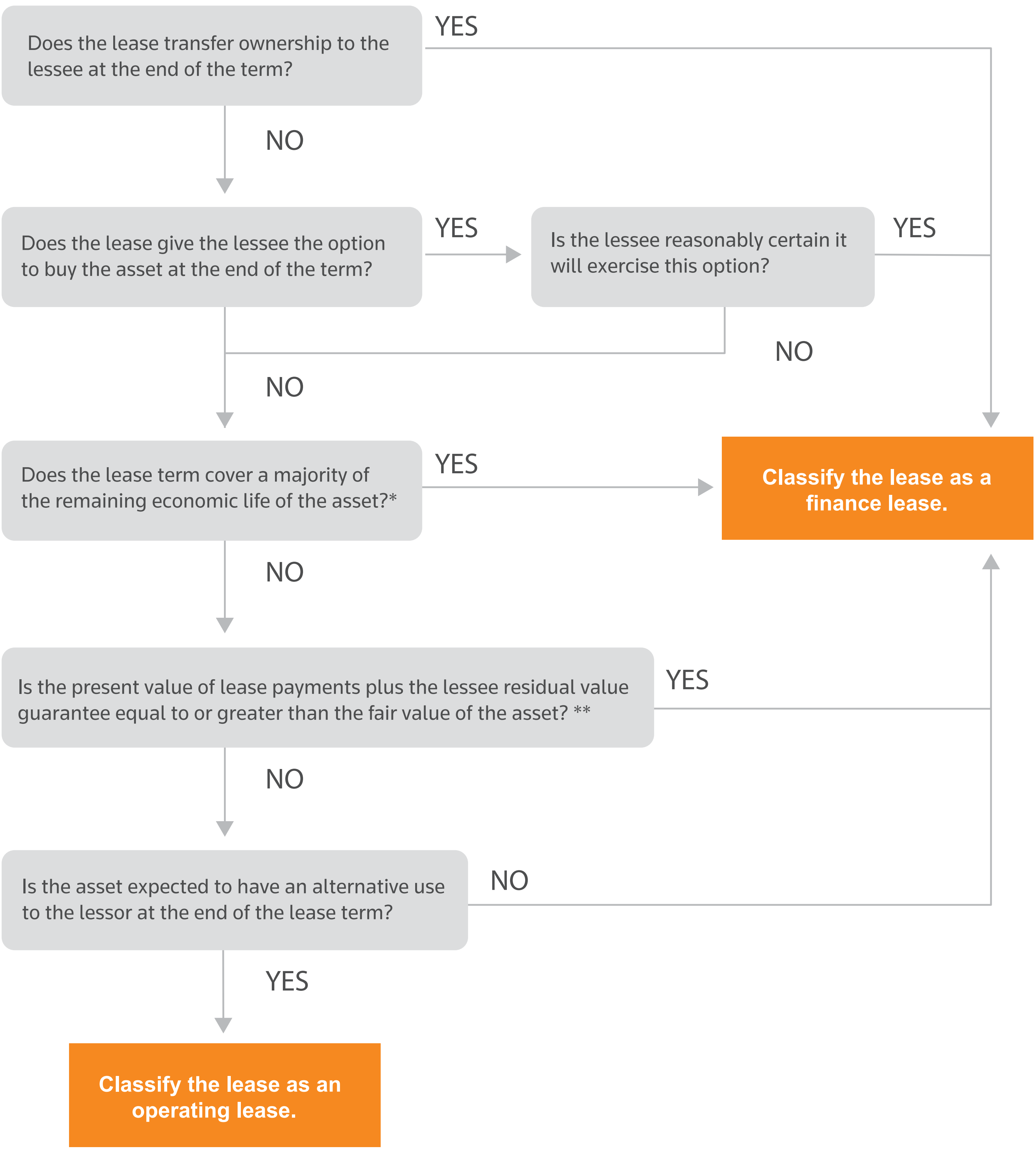
Lessors must classify their leases as operating leases, sales-type leases or direct-financing leases. As compared to Topic 840, Topic 842 includes an additional criterion regarding the classification of a lease: If the leased asset is so specialized that it is not expected to have an alternative use to the lessor at the end of the lease, then the lease is a finance lease for the lessee and a sales-type lease for the lessor.

Lease Classifications

Lessees		Lessors
Finance	Provides a lessee with the right to both: (1) Direct the use of the underlying asset and (2) Obtain substantially all of the benefits from using the asset	Sales-Type
Operating	Provides a lessee with the ability to control the underlying asset	Operating or Direct Financing

The classification of a lease is determined at inception and is not reassessed at a later date unless the contract is subsequently modified. The following decision tree depicts the process for a lessee to classify a lease as a finance or operating lease:

Lessee's Classification of a Lease



* If the lease commencement date is at or near the end of the economic life of the underlying asset, this does not apply (answer "No").

** The residual value guarantee in this calculation does not include amounts that are already reflected in the lease payments.

WG&L OBSERVATION: The lease classification is no longer relevant to the determination of whether an asset or liability is recognized by a lessee on the balance sheet. This is a significant change in lease accounting because Topic 840 only required the recognition of an asset or liability for capital leases. The lease classification under Topic 842 does, however, affect how revenues and expenses from the leasing arrangement are recognized.

WG&L OBSERVATION: A lessee must evaluate a leasing arrangement to determine whether it is a finance lease. The criteria for a finance lease are similar to the criteria for a capital lease under Topic 840. If the lease does not satisfy the criteria for a finance lease, it is classified as an operating lease.

WG&L OBSERVATION: Topic 840 included a number of criteria to consider when determining a lease classification. The following criteria included bright-lines:

- The lease term is equal to 75 percent or more of the estimated economic life of the leased property.
- The present value of the minimum lease payments at the beginning of the lease term is equal to or greater than 90 percent of the fair value of the property to the lessor (less any tax credits the lessor may realize).
- The commencement date of the lease falls within the last 25 percent of the economic life of the leased asset.

While these bright lines are no longer required under Topic 842, FASB ASC 842-10-55-2 suggests that these thresholds may still be used as a guide under Topic 842. Note that both Topic 840 and Topic 842 include other criteria for lease classification.

Lessees are now required to include nearly all leases on their balance sheets.

WG&L OBSERVATION: Lease classification under Topic 842 requires a lot of judgment. One of the areas where judgment is required is in the determination of the lease term. Lessees and lessors are now required to assess whether lease renewal options are reasonably assured to be exercised or termination options are reasonably assured not to be exercised.

New Accounting Model for Lessees in Topic 842

Recognition

Under Topic 842, a lessee must record the following in its balance sheet, regardless of lease classification:

All Leases

- A liability for lease payments (referred to as the lease liability) = Present value of lease payments
- An asset for the right to use the leased asset during the lease term (referred to as the right-of-use asset) = Lease liability + initial direct costs - lease incentives + prepayments

WG&L OBSERVATION: Lessees are now required to include nearly all leases on their balance sheets, which is a significant change from existing practice. A lessee may find it beneficial to begin reviewing its portfolio of leases to ensure that it has the appropriate information necessary to determine its lease assets and lease liabilities as required by Topic 842. Further, transition to the new guidance will likely affect key ratios, such as debt-to-equity and return on assets. Management is encouraged to prepare for the additional reporting and recordkeeping requirements early and to discuss the effect this standard has on reported or contractual financial ratios.

Similar to the guidance in Topic 840, a lessee must include the following payments in its measurement of these assets and liabilities:

- Payments during optional periods if the lessee is reasonably certain that it will either:
  - Exercise an option to extend the lease or
  - Not exercise an option to terminate the lease
- Payments to purchase the leased asset if the lessee is reasonably certain that it will exercise its purchase option

The term "reasonably certain" reflects a high threshold and is intended to be applied consistently with the term "reasonably assured" in Topic 840. Also consistent with the guidance in Topic 840, a lessee must exclude variable lease payments from its measurement of lease assets and liabilities, unless these payments are dependent upon an index or rate or are in substance fixed payments. Variable payments dependent upon an index or rate are included in estimated lease payments based on the index or rate at the commencement of the lease; this is a simplification from existing lease accounting guidance.

Short-term lease election:

If a lessee has a lease with a term of 12 months or less, it may make an accounting policy election (by leased asset class) not to recognize lease assets or lease liabilities. This election generally requires the lessee to recognize lease expense on a straight-line basis over the lease term.

Measurement

Under Topic 842, a lessee must distinguish between a finance lease and an operating lease in order to determine how to recognize the changes in lease assets and liabilities in the income statement. This classification is similar to the distinctions between a capital lease and an operating lease in Topic 840.

Operating Lease

- Single lease cost allocated on a straight line basis

Finance Lease

- Interest on lease liability
- Amortization of right-of-use asset

Under Topic 842 a lessee must distinguish between a finance lease and an operating lease.

Finance Leases

If a lessee has a finance lease, it must measure the right-of-use asset and lease liability at the present value of the lease payments on the balance sheet. Interest on the lease liability is recognized separately from the amortization of the right-of-use asset in the income statement. The statement of cash flows must also reflect the following classifications for a finance lease:

- Repayments of the principal portion of the lease liability are financing activities
- Payments of interest on the lease liability are operating activities
- Variable lease payments are operating activities

Operating Leases

If a lessee has an operating lease, it must measure the right-of-use asset and lease liability at the present value of the lease payments in the balance sheet. A single lease cost is recognized in the income statement. This single lease cost generally is recorded on a straight-line basis over the term of the lease. All cash payments for an operating lease are classified as operating activities in the statement of cash flows.

Private Company Considerations

Topic 842 permits a private company to use risk-free rates when determining the present value of lease liabilities.

Remeasurement

Under Topic 842, a lessee is required to remeasure lease payments under the following circumstances:

- A lease modification occurs that is not a separate contract
- A variable lease payment contingency is resolved (such as an event triggers the conversion of variable lease payments to fixed payments for the remainder of the lease term)
- A change occurs in any of the following:
  - The lease term
  - The reasonable certainty that an option will or will not be exercised
  - The probable amounts owed under a residual value guarantee

Variable lease payments dependent upon an index or rate (such as LIBOR) must be remeasured using the index or rate at the remeasurement date.

WG&L OBSERVATION: Right-of-use assets established from a leasing arrangement, regardless of lease classification, are subject to the impairment provisions of Topic 360, Property, Plant and Equipment.

Lease Components

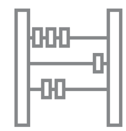
Under Topic 842, an entity is required to segregate the lease components from nonlease components in a contract. This requirement also exists in the provisions of Topic 840, however, this guidance is limited.

WG&L OBSERVATION: The FASB expects the separation of a contract into its lease and nonlease components under Topic 842 to be similar to how an entity separates a customer contract into performance obligations under Topic 606, Revenue from Contracts with Customers. In both cases, an entity must determine if a contract contains a single output or multiple separate outputs.

Topic 842 only applies to lease components in a contract and nonlease components must be accounted for in accordance with other applicable guidance. A lessee must allocate consideration in a contract between the lease and nonlease components on a relative standalone selling price basis. A lessor must perform this allocation in accordance with the allocation guidance in Topic 606. If a contract involves activities that do not transfer a good or service to the lessee or includes amounts paid only to reimburse the lessor for costs, these items are not components in the contract. No portion of the consideration in the contract can be allocated to these items.

Topic 842 additionally provides a practical expedient for lessees for the separation of lease components from nonlease components. A lessee can make an accounting policy election (by leased asset class) not to separate lease and nonlease components in a contract. If this accounting policy is elected, the lessee must account for the entire contract as a single lease component.

New Accounting Model for Lessors



ASU No. 2016-02 does not significantly change the accounting for a leasing arrangement by a lessor. There are, however, changes that lessors cannot overlook and that can result in a significant accounting exercise.

There are changes that lessors cannot overlook and that can result in a significant accounting exercise.

Under both Topic 840 and Topic 842, lessors generally recognize lease income on a straight-line basis over the lease term. The large majority of operating leases as defined in Topic 840 will remain operating leases under Topic 842.

Although lessor accounting is not fundamentally changed as a result of ASU No. 2016-02, some amendments have been made to conform the lessor guidance with the lessee guidance and other areas of GAAP, as follows:

- Certain glossary terms that are applied by both lessees (as a sublessor) and lessors have been amended so that both parties can use the same definitions.
- Certain provisions were amended to align the revenue-generating activities of lessors with the guidance in Topic 606.

  Previous lessor guidance under Topic 840 was derived from and aligned with the revenue recognition guidance in Topic 605, Revenue Recognition, that preceded the guidance in Topic 606. Consistent with Topic 606, Topic 842 requires a lessor to determine whether a lease is effectively the sale of the underlying asset. This determination hinges on whether the lessee obtains control of the underlying asset as a result of the lease, similar to the transfer of control principle in Topic 606. A lessor may not recognize sales profit or revenue at the beginning of a lease if the lease does not transfer control of the leased asset to the lessee. Topic 842 does not distinguish between leases of real estate or other assets.

WG&L OBSERVATION: Consistent with existing lease accounting guidance, a lessor must classify a lease as operating, direct financing or sales-type under Topic 842.

Sales-Type Lease	Direct Financing Lease	Operating Lease
Control of the asset is transferred from the lessor to the lessee	Control of the asset is not transferred to the lessee, but the lessor does not maintain control of the asset	Lessor maintains control of the asset

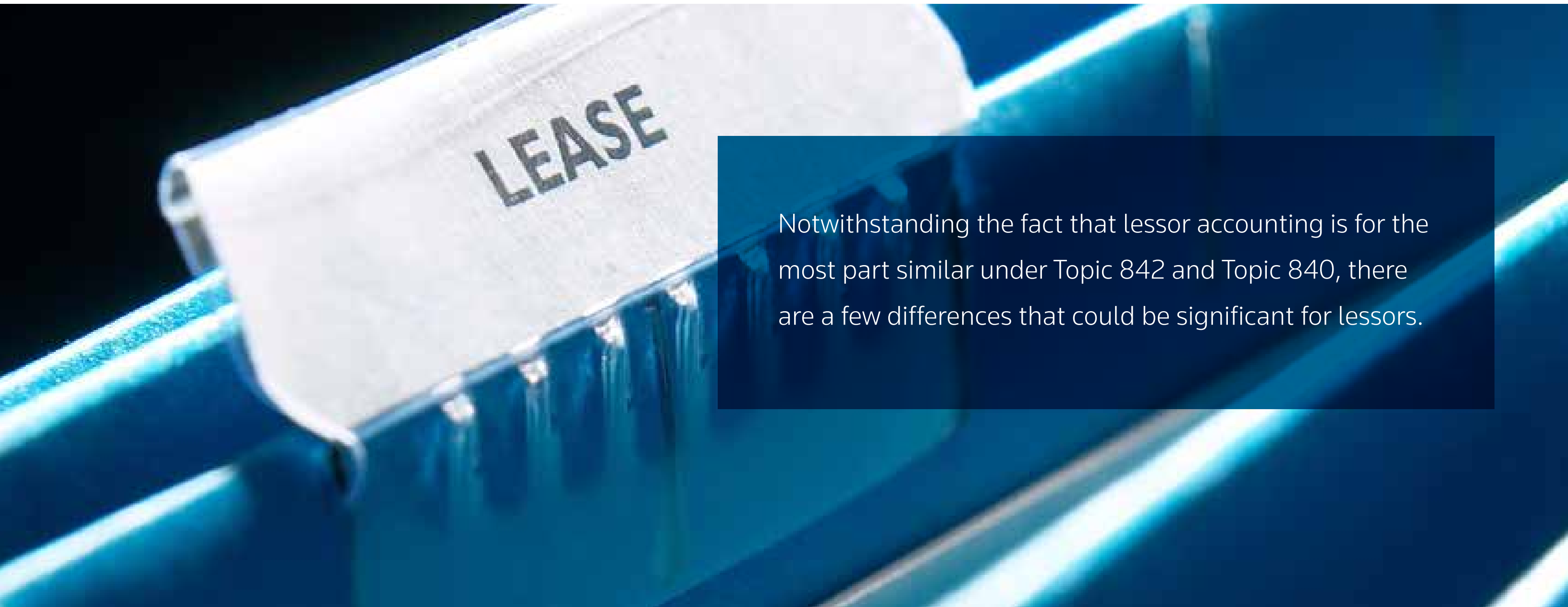
Notwithstanding the fact that lessor accounting is for the most part similar under Topic 842 and Topic 840, there are a few differences that could be significant for lessors:

- Uncertainty about the collectibility of lease payments and residual value guarantee is no longer a reason not to classify a lease as a sales-type lease. It will, however, affect when a lessor can derecognize the underlying asset and recognize lease payments in the income statement.
- Some leases with variable lease payments that were classified as operating leases under Topic 840 may now be classified as sales-type or direct financing, resulting in the possibility of a loss on the lease commencement date.
- Initial direct costs are more limited under Topic 842 than they are under Topic 840. Topic 842 defines initial direct costs as the incremental costs that would not have been incurred had a contract not been obtained. As a result, certain costs that were capitalized under Topic 840 may now have to be expensed when incurred.
- The timing of recognition of a profit or loss resulting from a sales-type lease may be different under Topic 842.

Topic 842 does not contain guidance specific to leveraged leases entered into after the adoption date of ASU No. 2016-02. Existing arrangements at the date of transition are grandfathered and entities may continue to apply the guidance specific to leveraged leases in Topic 840 to existing contracts. New contracts, however, cannot be accounted for as leveraged leases on a prospective basis. Similarly, entities will no longer account for a lease as a leveraged lease if a pre-existing leveraged lease is modified after the adoption of the guidance in Topic 842.

Sale and Leaseback Transactions

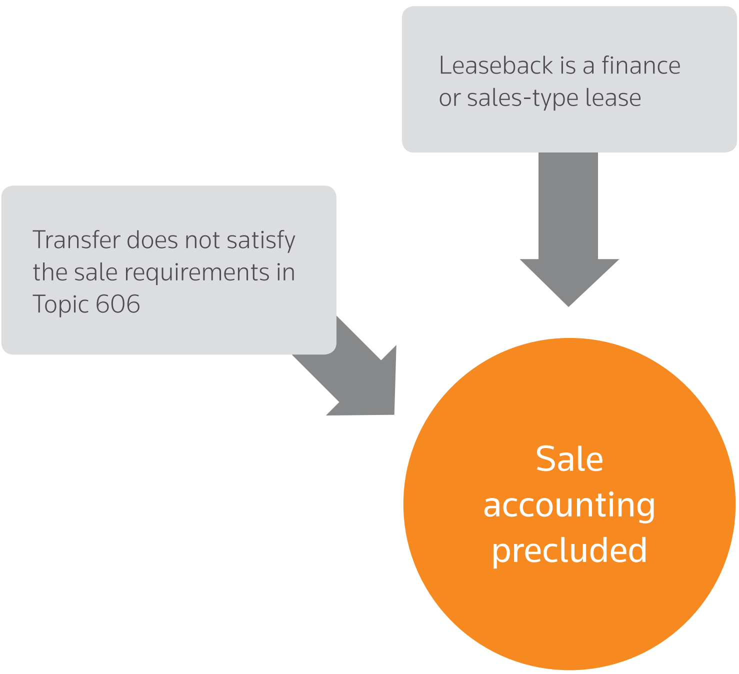
In order for a sale to occur in a sale and leaseback transaction under Topic 842, the asset transfer must satisfy the sale requirements in Topic 606. If the transaction does not satisfy these requirements, a sale has not occurred. The buyer-lessor is not permitted to account for a purchase if the seller-lessee cannot recognize a sale. This transaction is accounted for as a financing transaction by both parties.



Notwithstanding the fact that lessor accounting is for the most part similar under Topic 842 and Topic 840, there are a few differences that could be significant for lessors.

Topic 842 provides the following circumstances that preclude sale accounting:

- If the leaseback is classified as a finance lease by the seller-lessee or a sales-type lease by the buyer-lessor, the transaction does not qualify as a sale
- If the seller-lessee has an option to repurchase the asset from the buyer-lessor, the transaction does not qualify as a sale, unless the following conditions exist:
  - The asset is not specialized
  - The exercise price of the option is equal to the fair value of the asset on the exercise date



In order for a sale to occur in a sale and leaseback transaction under Topic 842, the asset transfer must satisfy the sale requirements in Topic 606, Revenue from Contracts with Customers.

Many real estate transactions that would not have qualified as a sale under Topic 840 will now qualify for sale and leaseback accounting under Topic 842. Conversely, many transactions involving non-real estate assets that would have qualified as a sale and leaseback transaction under Topic 840 will not qualify for sale and leaseback accounting under Topic 842. Refer to Section 842-10-55, Leases—Overall—Implementation Guidance and Illustrations, for further information on determining whether a transfer of an asset in a sale and leaseback transaction qualifies as a sale.

If a transaction was previously accounted for as a sale and leaseback under Topic 840, the entity is not required to reassess the transaction under the provisions of Topic 842.

WG&L OBSERVATION: This represents a significant change from the current accounting model. Because most leasebacks are operating leases, they are often not recognized on the balance sheet of the seller-lessee. In addition, gains on the sale of the asset are currently deferred and amortized over the lease term under Topic 840; they will be recognized immediately under Topic 842.

Transition Provisions and Next Steps

ASU No. 2016-02 is effective for interim and annual periods beginning after December 15, 2018, for any of the following:

- A public business entity
- A not-for-profit entity (including a conduit bond obligor) that has issued securities that are traded, listed or quoted on an exchange or an over-the-counter market
- An employee benefit plan that files financial statements with the U.S. Securities and Exchange Commission (SEC)

All other entities must apply the guidance in ASU No. 2016-02 for annual periods beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Any entity may early adopt the amendments in ASU No. 2016-02.

Public Companies

- Annual periods after December 15, 2018
- Interim periods after December 15, 2018

All Other Entities

- Annual periods after December 15, 2019
- Interim periods after December 15, 2020

Lessees and lessors are required to recognize and measure leases using the provisions of ASU No. 2016-02 at the beginning of the earliest period presented using a modified retrospective approach.

WG&L OBSERVATION: The FASB rejected allowing an entity to apply either a full retrospective approach or a prospective approach. The FASB wanted to limit the transition methods available in order to provide consistency across entities and make it easier for users of financial statements to understand and interpret the financial information presented.

ASU No. 2016-02 is effective for interim and annual periods beginning after December 15, 2018 for public entities.

A package of practical expedients exist related to the identification, classification and initial direct costs of leases that began before the effective date of ASU No. 2016-02, as well as the ability to use hindsight to evaluate lessee options to extend a lease, terminate a lease or purchase a leased asset. If an entity elects a practical expedient, it continues to account for leases that began before the effective date of the ASU in accordance with previous guidance with the following exceptions:

- A lessee is now required to recognize a right-of-use asset and a lease liability for all leases at each reporting date, measured at the present value of the remaining minimum payments that were tracked under previous guidance.
- A lessee must begin to apply Topic 842 if an event occurs that requires the lease liability to be remeasured.
- Both lessees and lessors must begin to apply Topic 842 if an existing lease is modified.

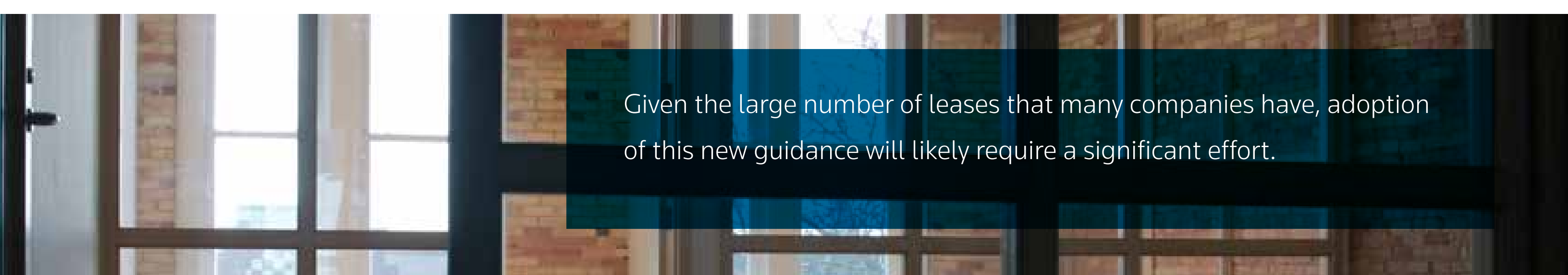
WG&L OBSERVATION: Most of the practical expedients must be elected as a package. This is to limit the potential ways that preparers might transition to the new guidance. An entity, however, is allowed to elect the practical expedient to use hindsight regardless of whether it chooses to elect the other practical expedients.

In the initial period of adoption, an entity must provide the transition disclosures required by Topic 250, Accounting Changes and Error Corrections, except for the disclosures in FASB ASC 250-10-50-1(b)(2).

The transitional guidance in ASU No. 2016-02 also includes specific provisions regarding:

- Sale and leaseback transactions
- Build-to-suit leases
- Leveraged leases
- Amounts that were previously recognized as part of a business combination

WG&L OBSERVATION: Lessors, in particular, may be interested in adopting the new lease standard early, in conjunction with the new revenue recognition standard. Both standards will require significant amounts of work and a lessor may leverage the work done for the implementation of one standard to implement the second one.



Next Steps

The effective date of ASU No. 2016-02 may seem far off in the future, but given the large number of leases that many companies have, adoption of this new guidance will likely require a significant effort. In addition, companies are already working on implementing the new revenue recognition standard and resources are likely to be strained.

Companies can get started on implementing ASU No. 2016-02 now. For instance, here are a few activities that companies can consider now:

- **Prepare an inventory of leases**: Because most leases were off balance sheet until now, many companies do not have a centralized inventory of leases with their key terms (such as renewal options). Starting early on this inventory can only help the implementation effort down the road.
- **Review the reporting systems used for leases**: For the same reason, many companies track their leases in Excel spreadsheets. Public companies will have to consider the controls in place around their systems and their adequacy and effectiveness. Private companies are encouraged to perform the same exercise.
- **Evaluate the new disclosure requirements**: Topic 842 includes increased qualitative and quantitative requirements for both lessors and lessees. Companies can get started on identifying their data gaps and identify solutions to gather the information that will have to be disclosed in the financial statements.
- **Involve other departments**: Because the addition of a large right-of-use asset and lease liability will affect key ratios, companies may want to review their debt covenants and other contractual triggers to renegotiate them as early as possible and draft new clauses in contracts. This will most likely require the involvement of several departments, such as treasury and legal.

The FASB has announced that it will not create a specific Transition Resource Group specific to leases. Companies are, however, encouraged to send their questions to the FASB, if any, through their regular inquiry process.

The new lease accounting guidance represents a significant change for lessees and even if the accounting for lessors represents less of a change, companies will still have to understand the details of the new guidance to be able to adopt it. Both lessees and lessors have to assess how pervasive the changes are to their specific situations in order to be able to plan for a smooth adoption of the new leasing standard.

The new lease accounting guidance represents a significant change for lessees and even if the accounting for lessors represents less of a change, companies will still have to understand the details of the new guidance to be able to adopt it.

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Understanding the FASB's New Standard on Leases

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The FASB's new standard on leases is a significant change to lease accounting, requiring, among other things, nearly all leases to be presented on the balance sheet. This webinar provides an overview of the guidance for both lessees and lessors with a focus on those provisions representing major substantive changes to financial reporting. The discussion includes illustrative examples and is focused on helping you understand the scope of changes and how they are likely to affect you.

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