<table>
<thead>
<tr>
<th>Area of Focus</th>
<th>Primarily Affects...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase transparency around lease obligations by requiring leases to be recorded on the balance sheet</td>
<td>Lessees</td>
</tr>
<tr>
<td>Better align the accounting with the revenue guidance in ASU No. 2014-09</td>
<td>Lessor</td>
</tr>
<tr>
<td>Improve disclosures around the unique accounting and risks faced by lessors</td>
<td>Lessor</td>
</tr>
</tbody>
</table>

**Summary of New Leasing Model in ASU No. 2016-02**

Leasing is an important source of financing for many entities. Leasing arrangements help businesses to gain access to assets, obtain financing or reduce exposure to the risks of ownership of an asset. Historically, financial reporting rules did not require lessees to recognize assets and liabilities arising from operating leases. Financial statement users are concerned that the lease accounting model under Topic 840 does not reflect the true economic substance of an operating lease transaction because it leaves a significant 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. To address these concerns, the FASB developed a new accounting model that supersedes Topic 840. Under the new accounting model in Topic 842, Leases, generally all leases are capitalized, leading to significant effects on the reporting and documentation requirements of financial statement preparers. Capitalization also is expected to affect key financial ratios, such as debt-to-equity and return on assets.

**Transition and effective dates**

For public entities, **ASU No. 2016-02 is effective for annual periods beginning after December 15, 2018, including interim periods within these annual periods. [§421-10-65-1(a)]**

For all other entities, **ASU No. 2016-02 is effective for annual periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020.**
DEFINITION OF A LEASE

NOTE: The lease guidance excludes the following assets:

1) Intangible assets (ex: IP)
2) Biological assets (plants, timber, livestock)
3) Inventory
4) Assets under construction (ex: building under construction)

The ASU defines a lease as a right to control the use of an asset for a period of time in exchange for consideration. The asset can come in various forms, such as property, plant, or equipment.

A contract can either:

- Be a lease in its entirety; or
- Contain a lease.

If a contract contains a lease, an entity must separate the contract into its lease (ex: right to use a piece of equipment for 3 years) and non-lease (ex: maintenance services for 3 years) components. An entity accounts for the lease components under Topic 842.

To evaluate if a contract is or contains a lease, there are two steps:

1) Existence of an identified asset
2) The customer’s right to control the use of an asset
   a) Right to all of the economic benefits (from using the asset)
   b) Right to direct the use of the asset

Specifically, if a contract is or contains a lease, an entity must record the contract on its balance sheet.

Prior to ASU 2016-02, the key factor that determined whether to recognize a contract on the balance sheet was how the lease was classified (for instance, as a capital lease or an operating lease).

LESSEE ACCOUNTING

The ASU makes substantial changes to how a lessee presents leases on the balance sheet. Prior to the ASU, GAAP did not require a lessee to record a lease asset and lease obligation for an operating lease. In other words, the balance sheet did not reflect the lessee’s right to use the asset or its obligation to pay for this right. The ASU, however, requires a lessee to record both a lease asset and a lease obligation for all leases greater than 12 months (including operating leases).

The ASU does not make substantial changes to how lessees must recognize the effects of leases in the income statement.

The ASU includes two classifications for lessees:
LEASE ACCOUNTING – ASU 2016-02 SUMMARY

1. Finance leases; and
   - Lease liability: unwind using the effective interest rate method
   - Right-of-use asset: amortize on a straight line basis

2. Operating leases
   - Lease liability: unwind using the effective interest rate method
   - Right-of-use asset: amortize to achieve straight-line total lease expense

The FASB generally expects most leases that were classified as a capital lease prior to ASU 2016-02 to be a finance lease. Similarly, the FASB anticipates that most operating leases will continue to be operating leases.

Example:

Facts:

1. 5 year lease with no renewal options
2. Lease payment is $50,000 paid at the end of each year
3. Lessee borrowing rate is 6%

Lease Liability is $210,618.19 (PV of 5 payments of $50,000 discounted at 6%)

Right of use asset is $210,618.19 (no initial direct costs, prepaid lease payments or lease incentives)

Finance Lease:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right of use asset</td>
<td>42,123.64</td>
<td></td>
</tr>
<tr>
<td>Amort expense</td>
<td>42,123.64</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>37,363</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>12,637</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>50,000</td>
</tr>
</tbody>
</table>
LEASE ACCOUNTING – ASU 2016-02 SUMMARY

Operating Lease:

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right of use asset</td>
<td>37,363</td>
<td></td>
</tr>
<tr>
<td>Lease liability</td>
<td>37,363</td>
<td></td>
</tr>
<tr>
<td>Lease expense</td>
<td>50,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>50,000</td>
</tr>
</tbody>
</table>

Short term leases

For lessees, the ASU allows an accounting policy election for leases with a term of 12 months or less. A lessee that makes this accounting policy election does not recognize lease assets and lease liabilities on the balance sheet. Instead, the lessee records lease expense on a straight-line basis over the period of the lease. A lessee makes this accounting policy election by class of underlying asset.

This accounting policy election is only available for lessees (not lessors).

In general, the most significant difference between the previous and new accounting models relates to the requirement for a lessee to recognize operating leases on the balance sheet. The lessee does so by recognizing a right-of-use asset and a lease liability.

Other notable differences for lessees include:

- Using different residual value guarantee amounts for finance (capital) leases;
- Using a secured, rather than an unsecured, incremental borrowing rate;
- Evaluating whether to adopt an accounting policy for short term leases;
- Having to reassess and remeasure leases for various events;
- Performing tests of impairment on operating lease right-of-use assets;
- Accounting for lease modifications; and
- Providing increased levels of disclosures as described in Disclosures–Lessees.
LEASE ACCOUNTING – ASU 2016-02 SUMMARY

Lessor accounting

The ASU makes targeted improvements to the accounting by lessors. These targeted improvements focus on two main areas:

- Disclosure—The ASU adds disclosure to provide users of financial statements with more information about the accounting by lessors. The disclosures are intended to help users understand the unique risks to which lessors are exposed. For instance, lessors are exposed to the risk that the leased asset will have little or no residual value at the end of the lease term. The lessor also is exposed to the lessee's credit risk;

- Consistency with the revenue guidance—The ASU revises aspects of the lessor model to make the guidance more consistent with the revenue guidance. For instance, for a sale and leaseback transaction, the ASU requires a lessor to use the revenue guidance to determine if a sale has taken place.

The ASU includes three classifications for lessors:

1. Sales-type leases;
2. Direct financing leases; and
3. Operating leases.

Lease Term is the noncancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option or in which the exercise of those options is controlled by the lessor.

The FASB generally expects the accounting by lessors to be similar to the accounting prior to ASU 2016-02. For instance, the FASB anticipates that most operating leases will continue to be operating leases.

While there are changes for lessors, the effects may not be as significant as those for lessees. The FASB decided not to fundamentally change the existing accounting requirements for lessors. Instead, the Board made specific amendments primarily driven by a desire to have a single principles-based approach to account for leases, improve disclosures around the unique accounting and risks faced by lessors, and better align the lessor guidance with recently-issued revenue guidance in ASU No. 2014-09.

Some of the areas of change include:

- Classifying leases more frequently as sales-type instead of direct financing;
- Deferring selling profit for direct financing leases;
- Performing collectability testing;
- Applying less complex lease modification requirements;
- Determining which initial direct costs are expensed or deferred;
- No longer applying special provisions related to real estate leases; and
- Providing additional disclosures as described in Disclosures—Lessors.
Disclosure

As with any new standard, the ASU revises the disclosure requirements. The ASU requires both qualitative and quantitative disclosures about an entity's leasing arrangements. The disclosures provide users of financial statements with better information about the amount, timing, and uncertainty of cash flows from leases.

An entity must use a modified retrospective approach to apply the ASU initially. The ASU includes several practical expedients that an entity can elect as a package to make adoption of the new leasing model easier.

The new leasing model is expected to improve transparency and comparability across entities. Specifically, it will require assets and liabilities to be recorded on an entity’s balance sheet regardless of whether an entity chooses to buy or lease assets for use in its business. It will also provide users of financial statements with enhanced disclosures about an entity’s leasing activities.

Transition to the new standard:

Under Topic 842, all entities must apply a modified retrospective transition.

An entity can elect to apply the guidance initially as of:

• The beginning of the earliest period presented on the financial statements; or [842-10-65-1(c)(1)]
• The beginning of the period of adoption. [842-10-65-1(c)(2)]

Practical Expedient:

Available to both lessees and lessors.

The available practical expedients must be elected together as a package, as follows:

• Contracts with leases—An entity can elect not to reevaluate if a contract is or contains a lease. This applies to both expired and existing contracts [842-10-65-1(f)(1)];

• Lease classification—An entity can elect not to reevaluate the classification of a lease. This applies to both expired and existing contracts. [842-10-65-1(f)(2)] For instance, an entity can assume that existing leases that are classified as operating leases under Topic 840 will be operating leases under Topic 842. Likewise, the entity can assume that existing leases that are classified as capital leases under Topic 840 will be finance leases under Topic 842 [842-10-65-1(f)(2)]; and

• Initial direct costs—An entity can elect not to reevaluate initial direct costs. This applies to existing contracts. [842-10-65-1(f)(3)] For instance, if an entity has unamortized initial direct costs that were capitalized under Topic 840, the entity does not have to reevaluate if the costs would have qualified for capitalization under Topic 842.