Summary of the New Lease Accounting Standard

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued its new standard on accounting for leases. Under the new standard, a lessee is required to recognize most leases on its balance sheet, which is a significant change from today's accounting requirements.
This standard is effective for nonpublic entities for periods beginning after December 15, 2021.

Impact to the Balance Sheet

There will be an increase in assets and liabilities on the balance sheet. Under the original standard, leases were classified as either **capital leases** or **operating leases**. While capital leases were recorded on a company's balance sheet, the operating leases were not. The new standard changes the types of classifications and the balance sheet treatment. Going forward, under the new standards, both classifications of leases, **operating** and **finance**, will be capitalized on the balance sheet. There are a few exceptions, such as certain short-term leases less than or equal to 12 months in duration. However, in most cases a **right-of-use (ROU) asset** will be recognized on the balance sheet along with a corresponding **lease liability** for the lease obligation.

Impact to the Income Statement

The treatment of operating and finance leases will differ on the income statement under the new standard. For **finance leases**, the interest and amortization of the lease are presented separately on the income statement. However, for **operating leases**, the two are combined into a single line-item. With operating leases, a straight-line expense profile typically results. With finance leases, the expense profile is typically front-loaded due to the separate interest on the lease liability.

What are Right-of-Use Assets and Lease Liabilities?

- **Right-of-Use Asset**
  The **right-of-use asset** is valued as the initial amount of the lease liability plus any initial direct costs and lease payments made prior to the commencement date, and minus lease incentives.

- **Lease Liability**
  The lease liability is calculated as the present value of the lease payments, using the discount rate specified in the lease, or if that is not available, the company's incremental borrowing rate (IBR).

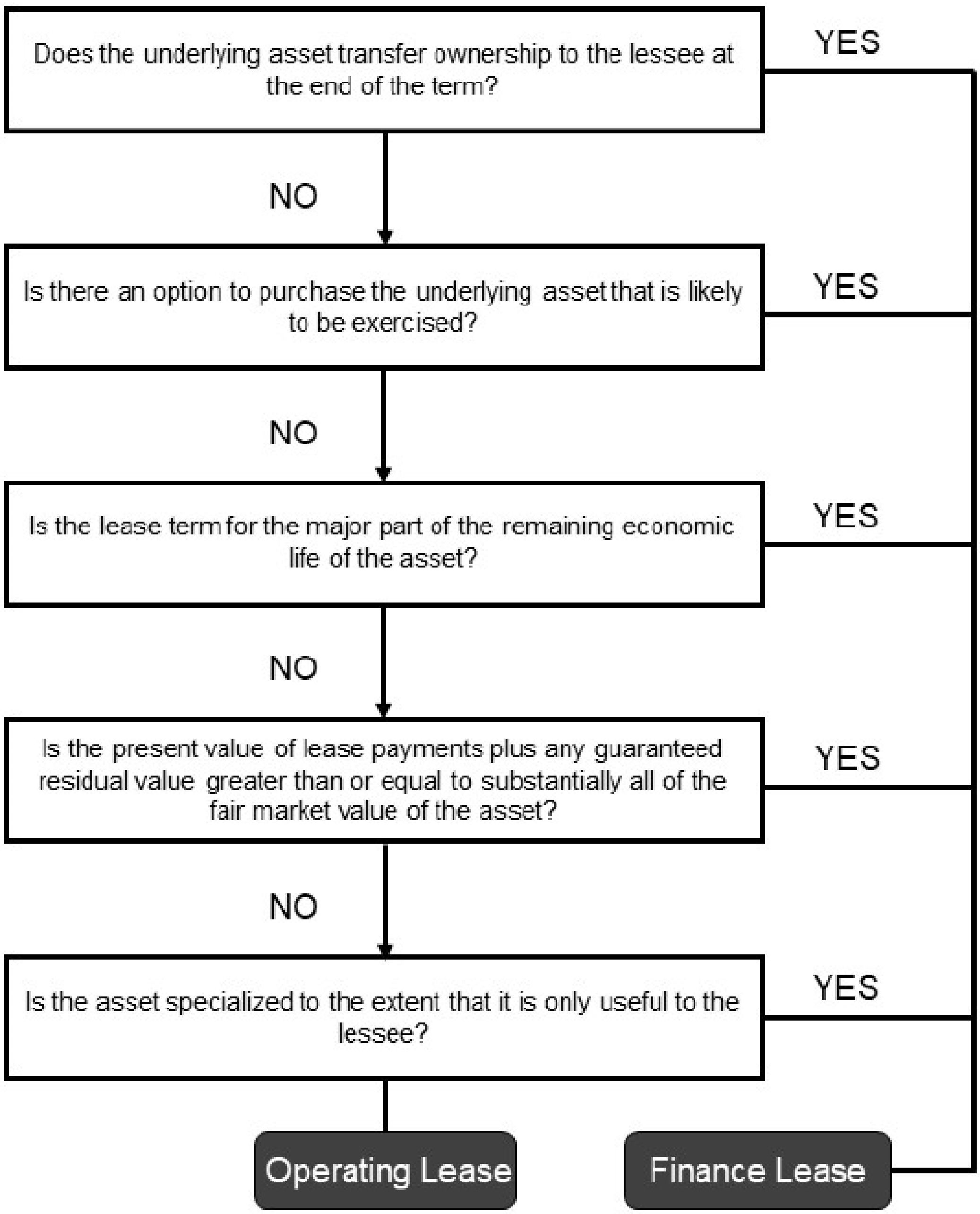
To qualify as right-of-use asset, the contract must meet 3 criteria:

- **Identified Asset**
  There must be an identified asset. To qualify as identified, the asset must be physically distinct or the lessee must receive substantially all of the capacity of the asset. In addition, the lessor cannot have substantive rights to substitute the asset.

- **Economic Benefit**
  The lessee must receive substantially all of the economic benefit. To determine what qualifies as "substantially all," the parties must define the economic benefits of the asset and then determine the allocation of economic benefits.

- **Direct the Use of Asset**
  The lessee must have the right to direct the use of the asset. If how the asset will be used was predetermined, the lessee must have the right to operate the asset or they must have designed the asset in a way that predetermines how it will be used.

Determining whether a lease is operating or finance:



Examples

Initial Measurement of ROU Asset and Lease Liability

On January 1, 2020, Austin Company enters into a lease with ABC Realty for office space for a 10-year term. The right to use the office space is a lease and there are no other components of the contract.

The following facts are relevant at the lease commencement date:	
Commencement date of the lease	January 1, 2020
Lease payments	Fixed payments of $14,527 per year in arrears, with a 3% increase every year
Termination/purchase options	None
Transfer of ownership	No
Residual value guarantee	None
Austin's incremental borrowing rate (implicit rate cannot be determined)	10%
Initial direct costs	$5,000

Accordingly, the contractual payments for the non-cancellable lease period are as follows:	
2020	14,527
2021	14,963
2022	15,412
2023	15,874
2024	16,350
2025	16,841
2026	17,346
2027	17,866
2028	18,402
2029	18,954
Total	**$166,535**

At the lease commencement date, Austin recognizes a lease liability of $100,000. This is the present value of the 10 lease payments (starting at $14,527 and escalating at 3% per year), discounted at Austin's incremental borrowing rate of 10%.

Austin recognizes a corresponding ROU asset of $105,000, which is calculated as follows:

- $100,000 lease liability + $5,000 initial direct costs

Austin would record the following journal entry at January 1, 2020:

Account	Debit	Credit
ROU Asset	105,000	
Lease Liability		100,000
Cash		5,000

Subsequent Accounting for an Operating Lease

In the previous example, Austin Company recognized a lease liability of $100,000 and an ROU asset of $105,000 for its lease of office space with ABC Realty.

Also, assume the following:

- Remaining economic life of office space: 35 years
- Fair value of office space: $400,000

Accordingly, Austin classifies the lease as an operating lease, because none of the tests for classification as a finance lease are met. As a result, Austin recognizes a single lease cost of $17,154 each year of the 10-year lease, which is calculated as follows:

- Remaining lease cost $171,535 (Total lease payments for the lease term $166,535 + Total IDCs recognized $5,000) / Lease term of 10 years

Assuming the lease is not modified and there is no remeasurement of the lease liability, the lease would be amortized as follows:

Year End	Expense (A)	Payment (B)	Interest (C)	Principal (B) – (C)	ROU Amortization (A) – (C)
12/31/20	17,154	14,257	10,000	4,527	7,154
12/31/21	17,154	14,963	9,547	5,416	7,607
12/31/22	17,154	15,412	9,006	6,406	8,148
12/31/23	17,154	15,874	8,365	7,509	8,789
12/31/24	17,154	16,350	7,614	8,736	9,540
12/31/25	17,153	16,841	6,741	10,100	10,412
12/31/26	17,153	17,346	5,731	11,615	11,422
12/31/27	17,153	17,866	4,569	13,297	12,584
12/31/28	17,153	18,402	3,239	15,163	13,914
12/31/29	17,153	18,954	1,723	17,231	15,430
Totals	**171,535**	**166,535**	**66,535**	**100,000**	**105,000**

Austin would record the following journal entry at December 31, 2020 (with similar entries throughout the term of the lease):

Account	Debit	Credit
Lease Liability	4,527	
Lease Expense	17,154	
ROU Asset		7,154
Cash		14,527

Accounting for a Finance Lease

On January 1, 2020, Yosemite Company enters into a lease with XYZ Equipment for a piece of equipment for a 10-year term. The right to use the equipment is a lease and there are no other components of the contract.

The following facts are relevant at the lease commencement date:	
Commencement date of the lease:	January 1, 2020
Lease payments:	Fixed payments of $14,527 per year in arrears, with a 3% increase every year
Renewal options:	None
Termination/purchase options:	None
Transfer of ownership:	No
Residual value guarantee:	None
Remaining economic life of equipment	12 years
Yosemite's incremental borrowing rate (implicit rate cannot be determined)	10%
Initial direct costs	$5,000

Accordingly, the contractual payments for the non-cancellable lease period are as follows:	
2020	14,527
2021	14,963
2022	15,412
2023	15,874
2024	16,350
2025	16,841
2026	17,346
2027	17,866
2028	18,402
2029	18,954
Total	**$166,535**

At the lease commencement date, Yosemite recognizes a lease liability of $100,000. This is the present value of the 10 lease payments (starting at $14,527 and escalating at 3% per year), discounted at Yosemite's incremental borrowing rate of 10%.

Yosemite recognizes a corresponding ROU asset of $105,000, which is calculated as follows:

- $100,000 lease liability + $5,000 initial direct costs

Yosemite would record the following journal entry at January 1, 2020:

Account	Debit	Credit
ROU Asset	105,000	
Lease Liability		100,000
Cash		5,000

Yosemite expects to consume the ROU asset's future economic benefits evenly over the lease term. Accordingly, Yosemite amortizes the ROU asset on a straight-line basis over 10 years.

Assuming the lease is not modified and there is no remeasurement of the lease liability, the lease would be amortized as follows:

Year End	Payment (A)	Interest (B)	Principal (A) – (C)	ROU Amortization
12/31/20	14,527	10,000	4,527	10,500
12/31/21	14,963	9,547	5,416	10,500
12/31/22	15,412	9,006	6,406	10,500
12/31/23	15,874	8,365	7,509	10,500
12/31/24	16,350	7,614	8,736	10,500
12/31/25	16,841	6,741	10,100	10,500
12/31/26	17,346	5,731	11,615	10,500
12/31/27	17,866	4,569	13,297	10,500
12/31/28	18,402	3,239	15,163	10,500
12/31/29	18,954	1,723	17,231	10,500
Totals	**166,535**	**66,535**	**100,000**	**105,000**

Yosemite would record the following journal entry at December 31, 2020 (with similar entries throughout the term of the lease):

Account	Debit	Credit
Lease Liability	4,527	
Amortization Expense	10,500	
Interest Expense	10,000	
ROU Asset		10,500
Cash		14,527

If you have questions, contact us. We are here to help.