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Audit Alert: FASB issues new lease accounting standard

On February 25, 2016, the FASB released Accounting Standard Update (ASU) 2016-02, Leases, the expected standard that will change the way leases are recorded. The purpose of this ASU is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and also disclosing key information about the leasing arrangements. To address this purpose, FASB created Topic 842, Leases, which replaces the guidance in ASC Topic 840.

Overview

The new standard defines a lease as a contract, or part of a contract, that conveys the right to control the use of identified property, plant and equipment (an identified asset) for a period of time in exchange for consideration. Control over the use of the identified asset means that the customer has both (1) the right to obtain substantially all of the economic benefits from the use of the asset and (2) the right to direct the use of the asset.

ASU 2016-02 includes a lessee accounting model that recognizes two types of leases: finance leases (currently known as capital leases) and operating leases. A lease is classified as a finance lease for a lessee and a sales-type lease for a lessor, if the lessee effectively obtains control of the underlying asset, and this is achieved if the lease meets any of the following criteria at the commencement of the lease:

- the lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- the lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- the lease term is for the major part of the remaining economic life of the asset. Entities will disregard this criterion if the lease commences at or near the end of the asset's useful life.
- the present value of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially the fair value of the underlying asset.
- the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

When none of these criteria are met:

- a lessee shall classify the lease as an operating lease.
- a lessor shall classify the lease as either a direct financing lease or an operating lease. A lessor shall classify the lease as an operating lease unless both of the following criteria are met, in which case the lessor shall classify the lease as a direct financing lease:

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March 11, 2016

1. the present value of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments and/or any other third party unrelated to the lessor equals or exceeds substantially all of the fair value of the underlying asset.

2. it is **probable** that the lessor will collect the lease payments plus any amount necessary to satisfy a **residual value guarantee.**

Recognition and measurement

Lessee

ASU 2016-02 requires a lessee to record a right-of-use asset and a lease liability. The lease liability is based on the present value of the lease payments, while the right-of-use asset is equal to the sum of: (1) amount of initial measurement of lease liability, (2) payments made by a lessee to a lessor before the commencement date minus any lease incentive received and (3) any initial direct costs incurred by the lessee.

While the measurement of the right-of-use asset and lease liability are the same for operating and financing leases, the recognition of the expense and the amortization of the asset differ.

Operating leases are recognized in a similar pattern to that described under ASC 840, where rent income or expense is recognized on a straight-line basis over the term of the lease. The straight-line expense will reflect the interest expense on the lease liability and the amortization of the asset. The amortization is calculated as the difference between the total straight line expense and the interest expense on the lease liability for the period. Lease expense will be presented as a single line item in the operating section of the income statement.

Finance leases will reflect a pattern similar to the one of current capital leases. The interest expense on the lease liability and the amortization of the asset will be reflected separately on the income statement.

The new standard provides for the election of a new practical expedient for short term leases. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term.

Lessor

The new standard adopts an approach for lessors that is substantially equivalent to existing US GAAP for sales-type leases, direct financing leases, an operating leases.

Financial statement presentation

The recognition and presentation of the assets, liabilities, expenses and cash flows arising from this standard will be as follows:

Financial Statement	Finance Leases	Operating Leases
Statement of Financial Position	Right-of-use asset Lease liability	Right-of-use asset Lease liability
Statement of Operations	Amortization expense of right-of-use asset Interest expense	Single lease cost, generally on the straight-line basis
Statement of Cash Flows – Operating Activities	Interest expense	All cash payments
Statement of Cash Flows – Financing Activities	Principal payments on lease liability	None

Effective dates

The provisions of this Update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for public entities. For all other entities, the standard is effective for fiscal years after December 15, 2019 and interim periods within fiscal years after December 15, 2020. Early application is permitted for all entities.

Although these changes may not have an immediate impact, management must prepare to adopt the new standard that will impact significantly the treatment of leases and the financial position and results of operations of companies.

Please contact our Audit Department if you need assistance with the implementation of this standard. We are committed to keep you updated of all developments that may affect the way you do business in Puerto Rico.