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FASB proposes changes to lease accounting rules

On February 25, 2016, the Financial Accounting Standards Board issued a new lease accounting standard (ASC 842) to change how companies and organizations account for leases in their financial statements. The standard applies to any organization issuing financial statements in accordance with generally accepted accounting principles in the United States that leases assets such as real estate, vehicles, construction, and manufacturing equipment.

While public companies have already implemented the standard, private companies and other organizations must have it implemented for fiscal years beginning **after December 15, 2021**. Companies with a year-end of December 31 must have it implemented **as of January 1, 2022**.

Recently, FASB clarified issues of concern under Topic 842 that will impact both public and private entities. In this video, we will provide an overview of the new lease accounting standard and recent clarifications by FASB.

Background

The new lease accounting standard, ASC 842, is designed to bring greater transparency and comparability to financial statements by recognizing assets and liabilities related to most leases. This will allow financial statement users to better understand a company's leasing activity, the potential risks of those leases, and how much capital has been invested in them.

Under ASC 842, a lease is defined as "a contract, or part of a contract, that conveys 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 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." This definition is important because some of a company's contracts may now be classified as a lease and vice versa.

Under the previous standard, ASC 840, only capital leases had to be reported on the balance sheet, but now under ASC 842, operating leases have to be accounted for as well. This change means that entities must record capital and operating leases as both an asset and liability on their balance sheet. In the past, most entities simply recorded operating leases as an expense when it was paid, but they did not appear on the balance sheet. Now, entities must record future payments owed on the lease as a liability, while the right to use the leased property is recorded as an asset. For entities with significant leases, the new standard will increase reported assets and liabilities, potentially making the entity look more leveraged than in the past.

Clarifications to address stakeholder concerns

On September 21, 2022, FASB voted to propose changes to ASC 842.

Documentation of related-party leases

ASC 842 requires an organization to account for a lease that's under common control based on legally enforceable provisions. Stakeholders were concerned because some private entities don't have written documentation of related-party leases. As a result, many have been confused about what's considered "legally enforceable" and which leases must be reported on the balance sheet.

FASB members agreed to a proposal that entities should consider the written terms and conditions when determining whether a lease exists. They will not be required to determine whether those terms are legally enforceable. And, if no written terms exist, the entity is still to apply ASC 842 to any verbal or implicit agreements.

Leasehold improvements

Another issue concerns the recording of leasehold improvements. Specifically, what to do when there's a verbal, related-party transaction regarding leasehold improvements. When it comes to leasehold improvements, it's conceivable that the lease term could differ dramatically from the life of the improvement - and when there's no documentation of lease terms, it can be tricky to determine how leasehold improvements should be recorded.

In response to this issue, FASB members voted to propose an amendment to ASC 842 that specifies that leasehold improvements between entities under common control should be amortized by the lessee over the "useful life of the improvements (regardless of the lease term) as long as the lessee continues to use the underlying asset." If and when the lessee stops using the leased asset, it must be accounted for as a transfer between entities under common control.

It's important to note that this proposal stands to affect private entities more so than public entities because public organizations' leases tend to be arms-length, written agreements. It's more likely that verbal agreements take place among smaller private entities and nonprofits, which must comply with the new standard for the first time this year.

How should a business prepare?

To comply with the new standards, a company should identify and evaluate all existing leases and contracts that may fall under the ASC 842 lease definition. For each identified lease, the company will need to gather detailed information such as important dates, payment terms, details about the leased asset, lease and non-lease components, and any special lease terms. Additionally, the company must determine what interest rates need to be used in calculating the lease liabilities.

Final Thoughts

This document is intended to provide a brief overview of and the proposed amendments to the new lease accounting standard. It is not a substitute for speaking with one of our expert advisors. If you'd like to learn more or need help implementing these changes, please contact our office.

About BT & Co. CPAs

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We love numbers, but they don't fuel us. People are our greatest passion. What we do is serious work, but it doesn't have to be done void of personality and enjoyment- we don't ask our team to leave their uniqueness at the door. Our team redefines CPA daily.

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