February 25, 2016

FASB Understanding Costs and Benefits

ASU: Leases (Topic 842)

This document summarizes how the Financial Accounting Standards Board (FASB) considered the expected costs and benefits of its new Accounting Standards Update (ASU) No. 2016-02, *Leases* (Topic 842), and the process the FASB undertook in concluding that the expected benefits of the amendments in the ASU justify the anticipated costs[1].

The FASB issues new financial accounting and reporting standards only when the benefits of a standard—which include improvements in the relevance and neutrality of reported financial information—justify the costs it imposes on financial statement preparers to implement the new standard, and on users to consider and respond to the new information.

The FASB concluded that the expected benefits of the amendments in this ASU justify the anticipated costs.

Overview of Costs and Benefits of the New Leases Standard

BENEFITS	COSTS
Eliminates one of the largest sources of off-balance sheet financing Improved comparability More reflective of financial position of lessee Fewer opportunities to structure to obtain a reporting outcome Addresses practice issues for preparers	Implementation costs • Additional (limited) personnel costs to evaluate existing leases • Inputs already available due to current footnote requirement Recurring costs are minor, similar to those in current GAAP

The new standard responds to concerns—including concerns from users—to increase the transparency around lease obligations. To address these concerns, previously unrecorded off-balance sheet obligations will now be brought more prominently to light by presenting lease liabilities on the face of the balance sheet. Accompanied by enhanced qualitative and quantitative disclosures in the notes to the financial statements, users will be able to more accurately compare information from one company to another.

While, depending upon the nature and volume of leasing activity, companies are likely to incur costs associated with implementing the new requirements, those costs are not expected to be significant. Companies applying the new standard will be able to leverage many of their existing financial reporting processes, reducing costs associated with implementing it. This is because the core guidance to determine finance and operating leases will be applied similarly to today's guidance, and most of the underlying data needed to record the liability already is captured by companies to create the required footnote disclosure.

To allow time for a smooth transition, the ASU on leases will take effect for most public companies in 2019. For most other organizations, the ASU on leases will take effect in 2020.

Early application will be permitted for all organizations.

Background

Today in Generally Accepted Accounting Principles (GAAP), most lease obligations are not recognized on the balance sheet, as GAAP only requires on-balance sheet treatment for a narrow

[1]For a detailed explanation of the FASB's consideration of costs and benefits refer to the basis for conclusions in ASU 2016-02.

set of leasing activities. Further, transactions often are structured to achieve off-balance sheet treatment. As a result, companies that own their productive assets are not comparable with those that lease their productive assets. There also is little information disclosed about a company's leasing arrangements in the notes to the financial statements. Users often make adjustments to compensate for that lack of comparable information, developing rough approximations of a company's lease obligations to make comparisons between companies.

Common lease arrangements include real estate (office/retail), equipment (manufacturing/construction), and transportation (airplanes/trains, cars/trucks).

The FASB added the Leases project to its agenda amid concerns that current GAAP fails to provide financial statement users with sufficient information about a company's lease obligations. Current GAAP does not require organizations to recognize operating leases as liabilities on the balance sheet. In practice, the majority of leases (and related lease obligations) are classified as operating leases and, accordingly, are an often-cited source of off-balance sheet exposure.

In a 2005 U.S. Securities and Exchange Commission (SEC) report, it was estimated that SEC registrants held approximately $1.25 trillion off-balance sheet lease obligations. Based on these observations, the SEC urged the FASB to reconsider accounting guidance for leases.

A primary objective of the Leases project was to increase transparency for investors and other users of financial statements by presenting lease assets and liabilities on the balance sheet and improving disclosures about leasing arrangements.

The new ASU affects all companies and other organizations that lease assets.

In developing an approach to recognize leases on the balance sheet, the FASB considered feedback from a variety of stakeholders and decided that certain aspects of the lessee accounting model should remain consistent with current GAAP.

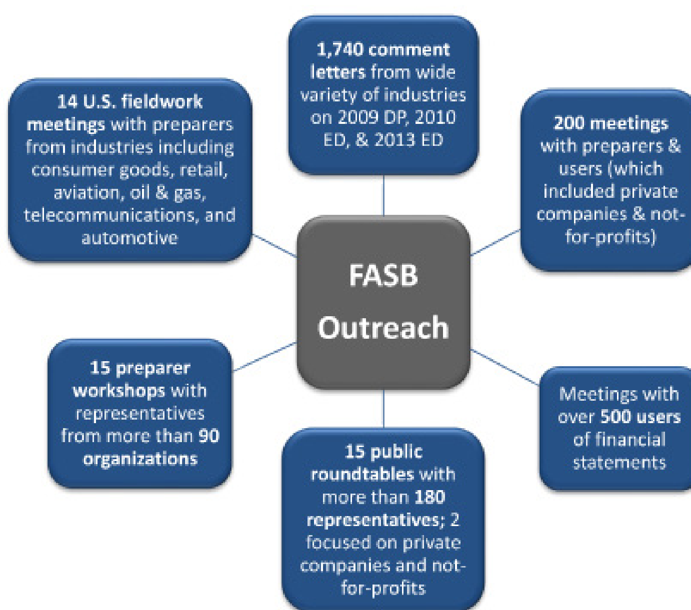
The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or an operating lease.

However, unlike current GAAP—which requires only capital (finance) leases to be recognized on the balance sheet—the ASU will require both types of leases (finance leases *and* operating leases) to be recognized on the balance sheet.

The FASB worked jointly with the International Accounting Standards Board (IASB) on this project[2]. While many aspects of the ASU are converged with the IASB's recently issued IFRS 16, the FASB's decision, as described above, to maintain the presentation of expenses and cash flows consistent with current GAAP are in direct response to U.S. stakeholder feedback to reduce costs associated with implementing the standard, and therefore differ from IFRS 16.

Outreach with Stakeholders

Since the project's inception in 2006, the FASB has requested and received significant input from stakeholders on the operationality and applicability of the proposed guidance. This input includes stakeholder responses to the proposed amendments in three public documents: the 2009 Discussion Paper (2009 DP), the 2010 Exposure Draft (2010 ED), and the 2013 Exposure Draft (2013 ED).



[2]The IASB separately issued IFRS 16, *Leases*, in January 2016.

When developing the guidance in the new ASU, the FASB participated in extensive outreach activities and received significant input from a wide variety of stakeholders (including both public and private companies and not-for-profit organizations).

The FASB's outreach activities included discussions about the potential costs and feasibility of implementing its proposals for improving the accounting for leases.

That outreach considered, among other things, the costs and relevance of the various lease accounting models that the FASB considered over the course of the project. Both preparers and auditors agreed that the approach to lessee accounting that the FASB decided to include in the new ASU was among the lowest cost options considered.

Stakeholder Concerns

The new ASU addresses many of the concerns raised by stakeholders about the costs and complexity of the proposals in the 2010 and 2013 Exposure Drafts. Largely in response to those concerns, this ASU:

- Includes a lessee accounting model that recognizes two types of leases (finance leases and operating leases).
- Uses a classification approach substantially similar to the classification approach in current GAAP. This decision, along with other simplifications described below, will allow many lessees to leverage their existing systems and processes to apply the requirements of the new ASU.
- Substantially retains the lessor accounting model in current GAAP.
- Includes a short-term lease exception for leases that are less than 12 months that aligns with the definition of the lease term.
- Allows a lessee to apply the leases guidance at a portfolio level for leases with similar characteristics.
- Simplifies the measurement of the lease liability relating to variable and optional lease payments and the reassessment requirements.
- Simplifies lessee expense recognition and the process for subsequently measuring the right-of-use asset in an operating lease.
- Allows lessees to separate the lease and nonlease components in all cases and estimate the standalone prices of those components.
- Clarifies application of the sale guidance in *Revenue from Contracts with Customers* (Topic 606) to sale and leaseback transactions.
- Simplifies the lessee and lessor disclosure requirements, principally by eliminating previously proposed reconciliation disclosures.
- Simplifies the transition requirements for lessees, lessors, leveraged leases, and sale and leaseback transactions, while clarifying the transition for build-to-suit leases.
- Allows private company and not-for-profit organizations to use risk-free rates for measurement of all lease liabilities.
- Provides an extended period between issuance and implementation to mitigate concerns raised about potential debt covenant violations.

Costs of Applying the New ASU:

- **Personnel costs to evaluate existing leases**
- **Costs to educate stakeholders about new reporting requirements**

Costs: Applying the New ASU

The FASB understands that some reporting organizations will incur additional costs as a result of the new ASU.

For example, organizations will, in general, incur initial costs to educate employees about how to apply the new requirements, and to explain to users the effects of the changes in accounting for leases on the organization's financial statements.

In addition, many organizations may need to consider supplemental processes and controls to ensure that they capture leasing activity on the balance sheet.

However, once these implementation activities are completed, the ongoing costs for most organizations of providing the information required by the new ASU are likely to be consistent with the costs of complying with the accounting model in current GAAP. The new ASU will not substantially change this level of effort. The FASB concluded that, based on substantial outreach with preparers of financial statements, many organizations will be able to apply the requirements of the new ASU using similar systems and processes to what they used to meet current GAAP reporting and disclosure requirements.

Benefits: Applying the New ASU

The FASB observed that the new ASU will provide benefits to many investors and other users of financial statements by increasing transparency of information and comparability among organizations. More specifically, the new ASU accomplishes the following:

- Results in a more faithful representation of a lessee's rights and obligations arising from leases.
- Requires lessees to recognize the lease assets and lease liabilities that arise from leases in the balance sheet.
- Requires disclosure of qualitative and quantitative information about lease transactions including information about variable lease payments and options to renew and terminate leases.
- Improves the understanding and comparability of a lessee's financial commitments regardless of how the lessee finances the assets used in its business.
- Clarifies the definition of a lease and aligns the concept of control, as it is used in the definition of a lease, more closely with the control principle in other areas of GAAP (*Revenue from Contracts with Customers* (Topic 606) and *Consolidation* (Topic 810)).
- Aligns the lessor accounting and sale and leaseback transactions guidance more closely to the comparable guidance in other areas of GAAP (*Revenue from Contracts with Customers* (Topic 606) and *Other Income* (Topic 610)).
- Provides users with additional information about lessors' leasing activities and lessors' exposure to credit and asset risk as a result of leasing.
- Results in fewer opportunities for organizations to structure leasing transactions to achieve a particular accounting outcome on the balance sheet.

Benefits of Applying the New ASU:

- **Increased transparency and comparability for users**
- **Addresses practice issues for preparers**
- **Fewer opportunities to structure**

Conclusion

The FASB's assessment of the costs and benefits of issuing this ASU is unavoidably more qualitative than quantitative because there is no identified method to objectively quantify all costs to implement the new guidance or to quantify the value of improved information in financial statements.

Overall the FASB concluded that the expected benefits of the amendments in the new ASU justify the anticipated costs.

More information on the ASU, including a press release, *FASB In Focus*, and a video, can be found on the FASB website.

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FASB FINANCIAL ACCOUNTING STANDARDS BOARD
401 Merritt 7, PO Box 5116
Norwalk, Connecticut 06856-5116
T: 203.847.0700 | F: 203.849.9714