**Issue Paper 2**

**Session 1: November 16-17, 2017**

**Issue:** Financial Accounting Standards Board (FASB) Accounting Standards Update, ASU 2016-2, Leases (Topic 842), and the Department’s Financial Responsibility Standards.

**Statutory Cite:** §487(c) and 498(c) of the Higher Education Act of 1965, as amended

**Regulatory Cite**: Subpart L of the General Provisions regulations, specifically 34 CFR 668.171 and 668.172 and the audit submission requirements under 34 CFR 668.23

**Summary of issue:**

The Higher Education Act requires all schools participating in the title IV programs to submit annual financial statements to the Department. ASU 2016-2 changes the way that all schools are required to account for leases by creating a new class of assets and a new liability that must be included in the schools’ financial statements. Under 34 CFR Part 668, the Department determines annually whether an institution is financially responsible, in part, by calculating a composite score based on information contained in its audited financial statements.

The core principle in accounting for leases is that a school should recognize the assets and liabilities that arise from leases. All leases create an asset and a liability for the school in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*, and, therefore, recognition of those lease assets and lease liabilities represents an improvement over previous Generally Accepted Accounting Principles (GAAP), which did not require lease assets and lease liabilities to be recognized for most leases.

A school should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. There continues to be a differentiation between finance leases and operating leases. However, the principal difference from previous guidance is that the lease assets and lease liabilities arising from operating leases should be recognized in the statement of financial position. ASU 2016-2 is silent on whether the right-of-use asset should be classified as an intangible asset, another asset, or property, plant, and equipment. For leases that are longer than 12 months, the liability associated with the lease would be considered a noncurrent liability.

Because a school may be recording large liabilities for operating leases, it may violate common debt covenants included in loan agreements. When a school violates loan agreement requirements, it is not financially responsible regardless of its composite score unless the creditor received and approved a timely waiver request.

There are also various transition requirements as schools move to full implementation of ASU 2016-2.

ASU 2016-2 provides for more extensive disclosures than was previously required to allow users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. To meet that objective, ASU 2016-2 requires qualitative disclosures along with specific quantitative disclosures. The intention is to require enough information to supplement the amounts recorded in the financial statements so that users can understand more about the nature of a school’s leasing activities.

Questions for consideration by the subcommittee include:

* How should the right-of-use asset be classified for purposes of the composite score?
* How should the lease liability be treated with respect to the right-of-use asset for the composite score?
* How should violations of debt covenants be treated by the Department in evaluating financial responsibility as a result of the changes from ASU 2016-2?
* How should any impact to a school’s financial statements be treated as a result of the transition requirements?
* Are there any specific disclosure requirements that should be specified in the regulations due to the discretion allowed in the new disclosures?