A PRACTICAL GUIDE TO LEASE ACCOUNTING BY LESSEES

How Will The New Requirements Under ASU 2016-02 Leases (Topic 842) Affect Your Business?

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BACKGROUND

For many years, the standard setters for both the U.S. and international generally accepted accounting principles have been dissatisfied with the rules for presenting lease arrangements in financial statements. The primary concern has been the presentation of lease contracts that qualified for "operating lease" accounting which had no requirement to recognize the long-term obligation on the balance sheet even though it was often unconditional – the financial statements only reflected the periodic lease cost as an operating expense. One European expert often observed that he flew on airplanes that never existed as an "asset" of the airline! In January 2016 for financial statements presented using international accounting standards, and in March 2016 for those using U.S. accounting standards, new standards for lease accounting were finally issued to resolve this issue.

In the U.S., the guidance is prescribed by Accounting Standards Codification Topic 842, Leases (the "Standard"). Simply stated, the new lease accounting model recognizes an asset, known as the "right-of-use asset," and a liability, the "lease obligation," on the balance sheet of the lessee for almost all lease contracts. The liability is equal to the present value of the lease payments. The carrying value of the asset is initially the same amount used to record the liability with some potential adjustments.

The Standard is effective for U.S. public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.

For non-public business entities, the Standard is effective for fiscal years beginning after December 15, 2019 and interim periods beginning the following year.

Early adoption is permitted.

For lessees, the pattern for expense recognition depends on whether the arrangement is essentially equivalent to a purchase or not. For leases that operate more like a purchase of the associated asset, similar to the prior concept of a capital lease, the lease is classified as a finance lease where the liability will be amortized like a loan with the expenses being higher in the front-end. For all other leases, which are classified as operating leases, the expense recognition pattern will be straight-line similar to the current operating lease model. Determining which classification will be used for a lease is based on criteria very similar to those used in the current model but without the bright lines (often referred to as the 75% test or the 90% test).

Along with the changes in classification of the lease, the Standard requires additional disclosures to provide greater insight into the lease activities of the lessee, including the significant judgements made by management.

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In summary, under the new standard, almost all leased assets and the related lease obligation will be recorded on a lessee's balance sheet. For some industries, such as retail and commercial aircraft, the impact on the lessee will likely be very significant. Also, if a lessee has debt covenants which involve balance sheet measures, this standard may affect those computations.

ABSTRACT

The following describes the accounting for leases under the Standard, as well as our practical observations and thoughts on implementation.

GETTING STARTED

If **your business under current accounting standards:**

- Is a lessee of an operating or capital lease
- Has contracts that qualify as in-substance leases
- Has sale-leaseback transactions or built-to-suit leases
- Has amounts previously recognized in accordance with the business combination guidance for leases

Then **your current business practices will need to be revised and new processes will need to be implemented to comply with the Standard, including:**

- Refined processes for analyzing the terms and conditions of contracts for use of tangible assets
- Process for calculating the present value of the contractual (i.e., lease) payments to determine the right of use asset and lease liability
- Implementation of tracking processes for leases including any periodic lease modifications

NEXT STEPS

A comprehensive impact analysis should be performed to compare what is required by the Standard to current practices in place. The impact analysis should identify the differences in not only the accounting for leases, but the required changes in the related business processes, internal controls and information systems that provide the needed accounting information.

To be successful, organizations will need to work in iterations across people, processes, accounting and technology systems. For example, as the accounting teams are working on the technical accounting requirements, operations would work on identifying the additional new business processes not already defined, while the IT teams work on portions of the systems based on new requirements that are defined to date.

GAAP GUIDANCE

PREREQUISITES

The new Standard focuses on whether a contract contains a lease as lessees will now be required to recognize lease assets ("right of use asset") and lease liabilities for all qualifying lease contracts. The amount of the asset and liability in the simplest case is the present value of the future payment stream.

Practical Observations

The new Standard will likely place obligations which could be significant on the balance sheet of lessees for the first time which will impact various liquidity metrics. For many borrowers, debt covenants will need to be revisited with lenders to adjust debt covenants to reflect the effect of this new presentation.

Also, financial forecasts and projections will likely need to be adjusted for the new expense recognition patterns.

THOUGHTS ON IMPLEMENTATION

- ✓ Companies should begin to inventory all contracts that qualify as leases under the Standard and summarize all financial terms relevant to accounting for them
- ✓ Companies should also survey vendors including their current software vendor to identify IT tools that will capture lease data to generate the information necessary to meet the accounting and disclosure requirements of the new Standard

DETERMINING LEASE TYPE

Contracts qualifying as lease will be classified as either:

1. Finance: Control of the asset is effectively transferred to the lessee. This is similar to the existing capital leases; or,
2. Operating Lease (lessee): Control of the asset is not effectively transferred to the lessee.

Control is considered to be effectively transferred to the lessee when:

1. The lease transfers ownership of the asset to the lessee by the end of the lease term
2. Lease grants the lessee an option to purchase the underlying asset which would be "reasonably expected" to be exerted
3. The lease term is for the major part of the remaining economic life of the asset
4. The present value of the sum of the lease payments is equal to or greater than substantially all of the fair value of the asset
5. The asset is so specialized that it is expected to have no alternative use to the lessor at the end of the lease term

Practical Observations

The Standard's definitions of control transfer is similar to previous GAAP; however, there is more room for management judgment. In previous GAAP, one criteria was a bargain purchase option, where the new Standard only requires a reasonable expectation to exercise the option to purchase at the end of the lease term. In addition, the lease term test and the present value test were changed to include more judgmental language.

THOUGHTS ON IMPLEMENTATION

- ✓ While no longer codified, generally, a reasonable approach to judge Lease Term Test and Present Value Test, respectively would be:
- ✓ Lease Term Test: 75%+ of the remaining economic life of the asset is considered a "major" part of the remaining economic life of the asset
- ✓ Present Value Test: 90%+ of the fair value of the asset amounts to "substantially" all of the fair value of the asset

LEASE ACCOUNTING

At the commencement of the lease, the lessee will recognize the right of use asset as follows:

1. The right to use the asset for the lease term
2. Initially measured at the present value of the future lease payments
3. Includes initial direct costs such as legal fees, advanced payments, lease incentives, etc.
4. Amortized on a straight-line basis for operating leases and a front-loaded expense pattern for finance leases
5. Lease liability
    a. Measured at the present value of the future lease payments
    b. For both finance and operating leases, the liability is amortized using the effective interest rate method

Practical Observations

The main technical accounting factor being added in this section is the calculation of the present value of the lease payments. The lessee should ensure this is being done properly, as many companies may not currently be required to calculate present value for any other financial statement accounts. In addition, the discount rate being used should be either the stated rate within the lease or the incremental borrowing rate for the lessee if the rate is not stated. Private company lessees can also elect to use the risk-free rate.

THOUGHTS ON IMPLEMENTATION

- ✓ Given the accounting requirements of this new standard for all periods presented, companies should consider implementing these calculations before the guidance becomes effective to reduce the amount of time spent during the year of adoption
- ✓ Note: the practical expedient offered under the modified retrospective approach, companies would not need to restate existing leases in accordance with the Standard unless modified after the effective date.

LEASE MODIFICATIONS

A modification is any change to the contractual terms and conditions of a lease. Lessee would account for a lease modification as a separate contract when the modification:

1. Grants the lessee an additional right of use asset, AND;
2. The price of the additional right of use asset is commensurate with its stand-alone price

Lessees would account for a lease modification that is NOT a separate contract by using the discount rate as of the modification effective date to adjust the lease liability and right of use asset for the change in the lease payments.

Practical Observations

Many companies frequently modify leases whether it be a renegotiation of rate or a lease extensions, and therefore, should be aware of the impact that modifications could bring about in time and expense related to the accounting treatment.

This adjustment could result in a gain or loss if the modification results in a full or partial termination of an existing lease.

THOUGHTS ON IMPLEMENTATION

- ✓ Additional or modified business processes and information system modifications will likely be required to comply with the recording/tracking of modifications required by the Standard

ADDITIONAL CONSIDERATIONS

SHORT-TERM LEASES

A lease that, at the lease commencement date, has a lease term of 12 months or less and the lessee concludes that it is not reasonably certain to exercise and extension options, and there are no other factors that would make exercise of the renewal option or any purchase options reasonably certain.

Practice Observations

The Company would recognize payments on a straight-line basis over the lease term with no asset or liability under simplified guidance. However, the company may make a policy election for this policy on an asset-class basis.

IMPAIRMENT

The Lessee should evaluate the right of use asset for impairment consistent with GAAP for long-lived assets.

Practical Observations

This requirement creates a need for implementing process into the control environment to ensure impairment analyses are included.

SUBLEASES

The head lease and the sublease are to be accounted for as two separate contracts.

Practical Observations

The sublease classification should be based on the underlying asset in the head lease.

SALE-AND-LEASEBACK:

A lease qualifies as a sale only if:

1. It qualifies as a sale under ASC guidance for revenue recognition, AND;
2. The leaseback is not a finance lease

The transaction is not a sale if there is a repurchase option unless the exercise price of the option is at the asset's fair value and there are alternative assets readily available in the marketplace.

Practical Observations

If the transaction qualifies as a sale, the entire gain on the transaction would be recognized.

THOUGHTS ON IMPLEMENTATION

- ✓ Additional or modified business processes and information system modifications will likely be required to comply with the recording/tracking of these certain other factors included in the Standard, to ensure potential elections made and that new impartment, subleases, and sale leaseback guidance is performed/accounted for as needed.

ACCESSIBLE EXPERTISE AT EACH STEP

Our team has the extensive experience to help you better understand the complexities and nuances of the Standard and in developing your own "impact analysis." Our goal is to effectively and efficiently model the impact of necessary changes to your financial reporting and business processes, internal control systems and information systems. We analyze the problems you face and deliver the solutions you need in the most holistic and cost effective ways—an approach measured by outcome rather than output.

SUCCESS BEYOND LEASE ACCOUNTING

Through our tailored end-to-end solutions, we help you control exposure to risks while reaping the benefits of a strategic approach to business management. Whether it's financial, operational, regulatory or technological changes, we provide comprehensive counsel that uncovers opportunities and reduces unwanted surprises.

The pertinent objective of our Risk Assurance & Advisory Services team is to consistently deliver high quality, distinctive services to our clients. Together with our Information Technology Audit and Compliance Group, we offer accounting and advisory services that extend beyond your immediate lease accounting and technical needs, but rather help you achieve your long term goals.

CONTACT US

Are you prepared for the new lease accounting standards? Our advisors are here to help. Contact us today.

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