Implementing the New Lease Accounting Standard

The public entity[1] adoption deadline for the new guidance in Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)* is drawing closer. Implementation and documentation thereof will be a significant undertaking for entities in all industries. The new guidance requires lessees to recognize substantially all leases on their balance sheets as lease liabilities with a corresponding right-of-use (ROU) asset. The ASU maintains the dual model for lessee lease classification and expense recognition similar to today's accounting. A lessor's approach for classifying leases is substantially similar to today for sales-type, direct financing and operating leases. Minimal changes were made to the lessor accounting model to align it with changes to the lessee model and the new revenue recognition standard. See Appendix Table 1 for a summary of the ASU's changes.

Effective Dates

Effective Dates Leases ASC 842 ASU 2016-02	**Public Entities[1]** Annual and interim reporting periods beginning after December 15, 2018	**All Others** Annual reporting periods beginning after December 15, 2019

Planning Considerations

Entities with leases should start preparing for this transition as soon as possible. The definition of a lease has changed, and both parties to a contract may need more resources to identify existing leases and structure new or existing agreements.

Implementation planning should include:

- Consider the implementation date. The revenue recognition standard is effective one year earlier than ASC 842. Nonpublic entities affected by both standards, especially lessors engaged in sale and leaseback transactions, may find it economical and operationally advantageous to early adopt the leases standard and implement both standards simultaneously.
- Inventory all arrangements within the scope of the new leases standard and gather required information. The definition of a lease determines that population, and as seen from the example, entities will want to give themselves adequate time to evaluate agreements against the multipart definition of a lease. To comply with the new leases standard, however, companies will need to do more than convert their footnote disclosures for operating leases to assets and liabilities, and significant manual effort may be required to gather additional lease information and determine completeness of the lease portfolio. For example, although the data requirements for measuring operating leases are similar to those required for disclosures of today's operating leases (with the exception of discount rates), lessees may not have separated lease and nonlease components of a contract and allocated consideration paid. Lessees may be accounting for leases embedded in a service agreement as a single contract, since their accounting treatment is often the same, and these agreements may not be included in existing lease disclosures. Separation is required under the new standard unless the lessee makes an accounting policy election, by

[1] A public entity is defined as any one of these:
- A public business entity
- A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC

class of underlying asset, not to separate lease components from nonlease components, in which case a lessee would account for lease and nonlease components together as a single lease component.

- Review terms of existing lease contracts to determine if options to extend or not terminate a lease are reasonably certain. This will be especially important for related-party leases if the entities are not consolidated. Entities also should review depreciable lives for leasehold improvements for related-party lease contracts as they relate to the lease term.
- Determine if accounting policy elections and practical expedients are available for your entity and if they should be adopted:
  - Election related to the recognition of short-term leases
  - Election by lessees not to separate lease components from nonlease component, by class of underlying asset
  - Election by lessees to use the risk-free discount rate for all leases in lieu of their incremental borrowing rate (available to all entities other than public business entities)
  - Use of portfolios to apply the lease guidance
  - Election of transition relief for leases that commenced prior to the effective date
- Consider the need for additional resources. A lessee needs the same information to apply both lease accounting models. However, since operating lease ROU assets and liabilities must be presented separately from finance lease ROU assets and liabilities, systems will need to identify the lease type as well. Existing lease administration applications, often spreadsheets, may include some lease information, but they may not have the information necessary for asset and liability measurement and to comply with the comprehensive qualitative and quantitative disclosure requirements. For accounting purposes, lessees may be incorporating capital lease assets into their fixed asset software, whereas existing operating lease assets are off the books. Since lessees will amortize ROU assets for operating leases differently than finance leases, the most affected entities may decide to invest in lease accounting software to capture the lease population and meet the accounting requirements.
- Educate the readers of the financial statements and evaluate how financial debt covenants will be affected.

Financial Ratios

Lease classification affects income statement recognition, equity and certain metrics. For lessees that currently have material off-balance sheet leases, the most significant effect of the new leases standard will be a gross-up in the balance sheet by increased lease assets and financial liabilities, affecting certain leverage ratios and performance ratios, *e.g.*, interest coverage and return on assets ratios, compared with current accounting. See Appendix Table 2 and 3.

An entity should assess the potential effect on its financial statements and metrics and evaluate how this may affect the way stakeholders view its financial position and performance. Lessees should discuss the new standard with their auditors and banks/creditors with covenants to understand implications of implementing the new standard.

Under the finance lease classification, the decrease in interest expense each year results in an increase in asset amortization each year. Thus, ROU assets and equity will decrease at a faster rate with finance leases than with operating leases.

For certain industries, the new rules may significantly affect an individual lessee's statement of financial position by increasing lease-related assets and liabilities, particularly lessees in the retail, financial services, shipping and other transportation-related industries, such as airlines and trucking. The dual model limits the effect of the changes on the income statement and statement of cash flows compared to today's standards.

For lessees that currently have material off-balance sheet leases, the most significant effect of the new standard will be an increase in lease assets and financial liabilities, affecting certain leverage and performance ratios, such as the interest coverage ratio.

Lessees will amortize ROU assets for existing off-balance sheet leases differently than today's capital leases, which are often incorporated into an entity's fixed asset software. The most affected entities may decide to invest in lease accounting software and redefine policies, procedures and internal controls to comply with the new requirements.

Lessor Considerations

Although lease accounting will not significantly change for most lessors, lessors may experience revenue recognition changes. Lessors will need to understand the effect of both the leases and revenue recognition guidance and the effect of the new standards on lessees. A customer's focus on the structure, terms and value of the lease may change, and certain lessees may want to negotiate shorter lease terms or discuss variable lease payments, which in turn may cause greater uncertainty in lease revenue.

Mutual Talking Points

From a balance sheet perspective, lessees will experience similar effects as if they were buying the asset. Lessees may focus more on getting the best deal for their company as opposed to ensuring the lease qualifies for operating lease classification and expect to work more with lessors for favorable terms and cost savings. In addition, lessees may need assistance in the allocation of consideration between the lease and nonlease components, with a desire to minimize the financial statement effect.

Determining whether a new contract contains or is a lease is the same regardless of the lease classification outcome. From an operational perspective, lessees will still face lease versus buy decisions, and most of the classic benefits of leasing remain intact. These benefits generally include convenience such as equipment upgrades or add-ons, service and matching of payments to cash flow needs, including flexible terms and structures such as extended payment options, potential low-cost financing compared to a loan and residual risk transfer (avoiding ownership of obsolete equipment). From a financial statement perspective, the amount a lessee is required to capitalize under an operating lease (present value of minimum lease payments) is expected to be lower than the capitalized cost of purchasing an asset, and the lease liability is nondebt.

We don't expect lessees in general to have a change in their lease versus buy decisions due to the new leases standard. The amount a lessee is required to capitalize under an operating lease (present value of minimum lease payments) is expected to be lower than the capitalized cost of purchasing an asset, the lease liability is nondebt, and many of the benefits of leasing remain intact.

Parties to sale and leaseback transactions will work closely together to ensure a sale occurs considering revenue recognition guidance and the new leases guidance.

In summary, entities will want to identify new lease information requirements, including additional qualitative and quantitative disclosures, and compare these to existing processes, policies, controls and system information-gathering capabilities. A lessee needs the same information to apply both lease accounting models under the new standard. This will entail developing consistent processes around judgments and estimates necessary to evaluate whether an arrangement contains a lease, separate lease and nonlease components of a contract and determine lease payments to be capitalized, the lease term and the discount rate. Processes and systems will need to capture events that require reassessments and/or when entities should reallocate the consideration in a contract upon a contract modification not accounted for as a new, separate contract.

Entities can then develop a plan to fill any gaps and implement new processes, policies, controls and systems to capture pertinent lease data and comply with the new requirements.

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Appendix

Table 1 – Comparison of Current & New Lease Accounting

Lessee Accounting – Comparison of Accounting for Financing Leases			
		Legacy GAAP **(Capital Leases)**	**ASU 2016-02** **(Finance Leases)**
Balance Sheet			
Recognition	Lease assets and liabilities on balance sheet	Yes	Yes
	Exemption for short-term leases	No	Yes
Measurement	Lease liabilities measured on a discounted basis	Yes	Yes*
	Initial lease asset = lease liability	Yes	Yes
	Amortization of lease asset	Generally on a straight-line basis	Generally on a straight-line basis
Presentation	Lease assets	Presented separately from owned assets, or presented together with the corresponding underlying assets as if they were owned, with disclosure of the line items that contain the capital lease assets and their amounts	Presented separately from owned assets, or presented together with the corresponding underlying assets as if they were owned, with disclosure of the line items that contain the finance lease ROU assets and their amounts
	Lease liabilities	Presented separately from other liabilities, or together with other liabilities with disclosure of the balance sheet line items that include the capital lease liabilities and their amounts	Presented separately from other liabilities, or together with other liabilities with disclosure of the balance sheet line items that include the finance lease liabilities and their amounts

Income Statement			
	Lease-related costs	Amortization of lease assets and lease-related interest expense presented separately	Amortization of finance lease ROU assets and lease-related interest expense presented separately
Cash Flows			
	Operating activities	Cash payment for the interest portion of the lease liability	
	Financing activities	Cash payments for principal portion of the lease liability	

* Lease liabilities initially recognized at the present value of lease payments

Lessee Accounting – Comparison of Accounting for Operating Leases			
		Legacy GAAP	**ASU 2016-02**
Balance Sheet			
Recognition	Lease asset and liabilities on the balance sheet	No	Yes
	Exemption for short-term leases	N/A	Yes
Measurement	Lease liabilities measured on a discounted basis*	N/A	Yes*
	Initial lease asset = lease liability	N/A	Yes
	Subsequent measurement of lease asset	N/A	Periodic amortization of the asset typically increases with time**
Presentation	Operating lease ROU assets	N/A	Presented separately from finance lease ROU assets with disclosure of related balance sheet line items that include the operating lease assets
	Lease liabilities		Presented separately from finance lease liabilities
Income Statement			
	Lease-related costs	Single lease or rent expense, generally straight line	

Cash Flow Statement		
	Operating activities	Cash payments for lease payments

* Lease liabilities initially recognized at the present value of lease payments

** On a periodic basis, lessees measure lease assets at an amount that achieves the recognition of a single lease expense typically on a straight-line basis

Table 2 – Example of Effect of Placing Existing Operating Leases on the Financial Statements

Balance Sheet				
	Current GAAP		ASU 2016-02	
Total Current Assets		33,000		33,000
Other	25,000		25,000	
Finance Lease Assets	2,200		2,200	
ROU Assets			20,500	
Property, Plant & Equipment	67,000		67,000	
Total Noncurrent Assets		94,200		114,700
Total Assets		**127,200**		**147,700**
Current Maturities of Long-Term Debt & Finance Leases	1,700		1,700	
Current Maturities of Operating Leases			5,000	
Other Current Liabilities	55,000		55,000	
Total Current Liabilities		56,700		61,700
Finance Lease Liabilities	1,200		1,200	
Operating Lease Liabilities			15,500	
Borrowings	26,000		26,000	
Total Liabilities		83,900		104,400
Equity		43,300		43,300
Total Liabilities & Equity		**127,200**		**147,700**

Income Statement		
	Current GAAP	**ASU 2016-02**
Revenue & Other Income	**175,000**	**175,000**
Cost of Sales	(150,000)	(150,000)
Gross Profit	**25,000**	**25,000**
Operating Costs	(11,700)	(11,700)
EBITDA	**13,300**	**13,300**
Depreciation & Amortization	(5,300)	(5,300)
Operating Profit	**8,000**	**8,000**
Net Finance Costs	(1,300)	(1,300)
Profit Before Tax	**6,700**	**6,700**
Income Tax	**(2,200)**	**(2,200)**
Profit for Year	**4,500**	**4,500**

Cash Flow Statement		
	Current GAAP	**ASU 2016-02**
Operating Activities	6,300	6,300
Investing Activities	(5,200)	(5,200)
Financing Activities	(3,400)	(3,400)
Total Cash Outflow	(2,300)	(2,300)
Leverage Ratios (Common Debt Covenant Ratios)		
Total Commitments (Borrowings plus Lease Liabilities) to EBITDA	**2.17**	**3.71**
Interest Cover (EBITDA to Net Finance Costs)	**10.23**	**10.23**
Performance Ratios		
ROCE: Return on Capital Employed (operating profit/(equity + borrowings + lease liabilities))	**11.1%**	**8.6%**

Table 3 – Lease Expense Recognition Differences

A lessee enters into a three-year lease with annual lease payments at the end of each year in the amount of $7,000, $8,000 and $9,000 at 8 percent interest. The following table illustrates the difference in accounting under the finance lease and operating lease approaches.

All Leases				Finance Leases					Operating Leases	
Year	**Lease Payment**	**Lease Liability (a)**		**ROU Asset (b)**	**Interest Expense**	**Amortization Expense**	**Total Expense**		**Lease Expense**	**ROU Asset (c)**
0		$20,485		$20,485						$20,485
1	$7,000	15,123		13,657	1,639	6,828	8,467		8,000	14,123
2	8,000	8,351		6,828	1,210	6,828	8,044		8,000	7,334
3	9,000	--		--	666	6,829	7,483		8,000	---
	24,000				3,515	20,485	24,000		24,000	

(a) Lease liability is reduced by the difference between the lease payment and the interest cost on the lease liability.

(b) Amortized on a straight-line basis.

(c) Reduced by the difference between the lease expense and interest cost on the lease liability.