The New Lease Standard: What You & Your Clients Need to Know

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The New Lease Standard: What You & Your Clients Need to Know

Michelle Freeman, CPA

For many years, operating leases have been an easy, legal and GAAP approved way of keeping debt off the balance sheet. That time has now passed.

Whether you are a public or private accountant dealing with leases from the lessee point of view, the new lease standard passed in Feb. 2016, will affect you-sooner than later. The purpose of this article is to inform you of what you need to know now in order to be an asset to your clients and not a liability!

The new lease standard began as a part of the IASB and FASB convergence project. The primary objective of the new lease standard is to "recognize all leases as assets and liabilities on the balance sheet" (Becker Professional Education 2016). Operating leases have been a popular form of off-balance sheet financing prior to this standard. According to FASB Chair, Russell G. Golden, quoted in Accounting Today, "The new guidance responds to requests from investors and other financial statement users for a more faithful representation on an organization's leasing activities," and he further states, "It ends what the US Securities and Exchange Commission and other stakeholders have identified as one of the largest forms of off-balance sheet accounting, while requiring more disclosures related to leasing transactions" (Cohn, Feb. 25, 2016, FASB Releases Lease Accounting Standard).

FASB approved the new Lease Standard in February 2016, and IASB released its final lease standard IFRS 16 on Jan. 12, 2016. The standard becomes effective for years beginning after Dec. 15, 2018 for public companies, some not-for-profits, and employee benefit plans. Private companies have an additional year beginning after Dec. 15, 2019.

In accordance with its purpose, the clients whose businesses will be most affected are those with several operating leases. Some examples of the types of industries most exposed include retail and distribution, automotive, telecomm, process and industrial products, travel, hospitality and leisure, consumer products, health care providers and power and utility boards (Cohn, June 6, 2016 Less than 10 percent of Companies Ready for New Lease Accounting Standards). "Big banks with many local branches will also have to account for the leases on those properties, while airlines will need to list the leases on the airplanes they fly" (Cohn, March 24, 2016 Plenty of Work Ahead for Lessors Adjusting to New Leasing Standard). A bigger surprise to investors will be tech companies as opposed to large airlines. For example, according to Tim Gaumer, a chartered financial analyst quoted in Accounting Today, the Amazon Web Services unit of Amazon.com, which carries $6.5 billion in operating leases, will "suddenly ... look a lot more leverage[d]" (Cohn, July 26, 2016 Metal in the Cloud: Tech Companies Need to Watch Out for New Leasing Standard).

According to Cohn, those clients with a large number of current operating leases will be affected in several ways. First of all, they will appear more leveraged. The Debt to Equity Ratio will rise significantly based on the number of operating leases that will now have the liability associated with those leases booked. There will also be a decrease in their Return-on-assets Ratio due to the fact that a corresponding asset will be booked. There may also be a decrease in Earnings-per-share based on the fact that an increased amount of lease expense which includes amortization of the asset will hit the income statement (Cohn, July 26, 2016).

There was definitely an advantage to negotiating leases as operating leases in the past in order to keep them off the balance sheet. Now, we may see businesses negotiate shorter term leases to achieve this objective because leases less than 12 months are not capitalized. (Cohn, February 25, 2016 Companies Will Need to Adjust to New Leasing Standard). However, this may have a price impact from the lessor due to the higher associated risks to the lessor from a short-term one-year lease than a multiple-year lease (Cohn, March 3, 2016). Lessors will have to charge a higher price to make up for that risk. As a result, some companies may decide to simply buy assets rather than lease them. According to Tim Gaumer, a chartered financial analyst quoted in Accounting Today, "If ordinary debt is less expensive, they might replace [leases] with [debt]... I imagine they'll choose whatever is the least expensive form of financing whether that's equity, debt or leases" (Cohn, July 26, 2016).

In order to be ready for the new lease standard, firms and industry accountants should start planning NOW! Although implementation appears to be two to three years away, firms need to begin collecting their lease data now so their "lookback reporting for 2017 and 2018" will be ready in 2019 (Cohn, June 6, 2016 Less than 10 percent of Companies Ready for New Lease Accounting Standards). According to Jim Kroeker, "companies should begin their process as soon as practicable...[as] the likelihood of successful implementation is probably increased proportionally by the time period in which one starts" (Cohn, Feb 25 2016 FASB Releases Lease Accounting Standard). Jared Rosen, a director at the Baltimore accounting firm, Ellin & Tucker and quoted by Accounting Today, states "it's going to take a lot of effort
to inventory all the leases that are currently out there as operating leases and then calculate the asset and liability amounts at the date of adoption in order to include them on the balance sheets.” (Cohn, Feb 25 2016 FASB Releases Lease Accounting Standard). CPA firms should encourage their clients to “capture data for new leases as they're entering into them now because they will be affected by the new standard if they're long term leases and [will] still be in place a few years from now” (Cohn, Feb. 25, 2016 Companies Will Need to Adjust to New Leasing Standard).

It appears that industry is somewhat procrastinating in dealing with this standard or are in denial. According to Cohn, as of June 2016 in a survey by Deloitte, "only 9.8 percent of financial and accounting professionals say their companies are prepared to comply with the new lease accounting standards" (Cohn June 6, 2016). "Eighty-three percent of the executives polled said they have not started to create a budget for meeting the new standard," and "only five percent reported they have designated more than $500,000 over the next three years to comply with the standard" (Cohn, June 16, 2016 Accounting Today’s Companies Struggle to Cope with FASB Leasing Standard).

The top challenges to the new standard included “collecting necessary data on all organizational leases in a centralized, electronic repository, ... [and] instituting reporting processes to evaluate quarterly adjustments for the balance sheet, along with profit and loss statements” (Cohn, June 6, 2016 Less than 10 percent of Companies Ready for New Lease Accounting Standards). Bill Bosco illustrates in an article for Accounting Today exactly how much work this standard could involve. He states that Walgreens is known to be the United States company with the highest number of operating leases, having approximately "8,400 real estate leases" last year. He states that if it takes one hour to input a lease into the accounting system, "that would translate into 8,000 man hours, the equivalent of approximately three man years’ worth of work," and this is not even taking into account the "company cars, trucks, cash registers, PCs, copiers and fax machines" that are also leased (Cohn, March 24, 2016 Plenty of Work Ahead for Lessees Adjusting to New Leasing Standard). This would be the equivalent of approximately “four or five man years of work for a company like Walgreens, so they’d better start to work on it right now” (Cohn, March 24, 2016).

Companies need to make a plan. Sheri Wyatt, managing director of PricewaterhouseCoopers’ Capital Markets Accounting Advisory Services and quoted in Accounting Today states that companies should start by "sitting down and identifying who your core team is going to be, and then laying out a project plan that will get you to a point where you are able to potentially quantify the impact of the new standard“ (Cohn, March 3, 2016 New Leasing Standard Could Benefit Companies). Jim Kroeker, FASB vice chairman states the following:

Large companies with many leases may want to consider new accounting software packages or updates. According to Torr in Accounting Today, "Most companies will need to revisit their technology around leasing ... Depending on what the company's current systems landscape looks like, most companies would need to have some modification to their technology to accommodate these new requirements” (Cohn, Feb. 25, 2016 Companies Will Need to Adjust to New Leasing Standard).

This new standard presents some benefits to our clients. Just like company coming to visit forces one to clean the house, the new lease standard forces companies to truly look at their "full leasing portfolio," and "by getting it all in one place, ... you have the ability to make those decisions [like how you handle assets at the end of a lease] in a consistent manner and that may result in better efficiency for the organization" (Cohn, March 3, 2016 New Leasing Standard Could Benefit Companies).

So how does the new standard change the way accountants have treated leases since the 1960s? Some of the main changes are highlighted in the remainder of this article. See Figure 1.

Lessee accounting changes dramatically under the new lease standard. See Figure 2.

Leases are defined as follows under the new standard: “Topic 842 defines a lease 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.” (ASU No. 2016-02, February 2016)

There are instances where assets have "substantive substitution rights," that may cause the contract to not qualify as a lease. When a contract is for an asset such as a coffee maker where the coffee maker is sometimes or regularly substituted, then a service contract would be more fitting than the lease of an asset (Becker Professional Education 2016). There are also times when the lessor has "protective rights" to keep the asset in good working condition over the life of the lease. In this case, if the asset is not regularly substituted or it might be difficult to do so based on the function of the asset, then lease treatment is probably still appropriate. An example of this type of situation might exist with a copy machine lease (Becker Professional Education 2016).

Another initial determination for the lessee considers the initial receipt of supplies with the leased equipment. Lessees can separate leased asset from supplies, OR they can elect "to NOT separate lease and non-lease components for given class of assets, and account for the whole contract as a lease" (Becker Professional Education 2016, Leases New Standard – ASU 2016-02).
In the past, leases were put into two categories: capital leases and operating leases. Although the terms still exist, their meanings and treatment of the corresponding leases are VERY DIFFERENT! With the new standard, almost any lease that has a term of more than 12 months will be considered a capital lease and will be capitalized on the balance sheet as an asset with a corresponding liability. Capital leases will be further classified as finance and operating leases. Again, both will be capitalized, but they will look differently on the income statement and cash flows statement.

Both capital finance and capital operating leases measure an asset (the amount of the lease liability adjusted for prepayments and direct costs) and measure a lease liability at the present value of lease payments to be made. The journal entry to accomplish this will look something like the following for both finance and operating leases:

Right-of-use asset xx (sum of liability and cash paid at onset of lease)

Lease liability xx (pv of lease payments)

Cash xx (amount of first payment if made at beginning of lease)

This is the same exact entry that would have been made for an operating lease under the new standard.

The balance sheet presentation will allow for leased assets to be combined with other assets, and for lease liabilities to be combined with other liabilities, but if they are combined, they must be disclosed in notes. However, financing lease assets and liabilities cannot be combined with operating lease assets and liabilities.

The income statement presentation of capital finance leases will differ from that of capital operating leases. Capital finance leases will recognize depreciation expense under continuing operations and interest expense as other expense, similar to the way capital leases currently express expenses associated with leases on the income statement. The journal entries would look similar to this for the first year of the lease:

Interest Expense xx (interest accumulated during year on the outstanding lease liability)

Lease liability xx

(Record interest expense for the year)

Amortization Expense xx (amount of right of use asset divided by number of years in lease)

Right of use asset xx

(Record amortization of the leased asset)

NOTE: Two expenses, interest expense and amortization expense, both hit the income statement

On the other hand, capital operating leases will recognize one lease expense in income from continuing operations (depreciation & interest are not broken out). The journal entry would look like the following:

Lease Expense xx (total payments divided by lease term)

Lease liability xx (interest calculated for the year on the outstanding lease liability)

Right of use asset xx (plugged difference between lease expense and interest recorded)

(Record lease expense for the year)
NOTE: Only one expense, “Lease Expense,” hits the income statement in continuing operations.

The journal entry to record the payment would look similar to the following:

Lease liability xx (amount of payment)

Cash xx

(Record payment)

Cash Flows Presentation of capital finance leases will show principle payments under financing activities and interest payments will follow ASC 230. Capital operating leases will show lease payments as operating activities. Short-term lease payments will be included with operating activities.

As stated earlier in the article, the new lease standard was initially part of the convergence project between the IASB and FASB; however, convergence was not completely achieved. The final standards issued by the IASB on January 12, 2016 and FASB in February 2016 have a few differences that clients dealing with multinational companies will need to know. A few of the most obvious differences between the standards follow. The IASB defines all capital leases as finance leases and makes absolutely no mention of capital operating leases. The IASB also has two exceptions to capital leases. Expense treatment without capitalization is acceptable under IASB for low value leases of $5,000 or less and for short term leases less than 12 months. Also, if an option to renew is available on a lease, then according to IASB, the short term option is not available. On the other hand, FASB capitalizes all leases as capital finance leases or capital operating leases and only has one exception to this treatment. Leases which are classified as short-term leases of less than 12 months may be expensed. FASB does not have a low-value exception. Also, according to FASB, the option to renew can be included in the lease contract, but if the company is reasonably certain to exercise it, then the short term lease treatment is not available.

The new lease standard brings several opportunities to your CPA firm. You will need to train your client's staff on how to comply with the accounting aspects of the standard. You should also try to help your clients understand the opportunity their businesses have to re-evaluate their leasing strategy and look at things like “maintenance management, space and facilities management and overall capital project management, and then optimize sustainability . . . you could actually improve certain of these processes . . . [optimize your equipment-leasing strategies]” (Cohn, May 17, 2016 Lease Accounting Standard Will Require Client Training). Compliance with the standard will require some training and work, but it might be work that is long overdue from an efficiency perspective for the overall business.

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“Start early and engage not just accountants, but others within the organization, whether that be the legal groups—if leases happen to be an important part of debt covenants or other contractual arrangements—make sure that the legal team understands the implementation, or your contracting team, or those who negotiate arrangements with other third parties are aware of the change. Involve IT if and when necessary. Come up with a team that looks at the standard That goes beyond financial reporting”

• (Cohn, Feb 25 2016 FASB Releases Lease Accounting Standard)