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New Lease Accounting Standard Can Trigger Dramatic Changes

6 Planning & Implementation Considerations

By Ronald Kral, CPA, CMA, CGMA
Managing Partner of Candela Solutions LLC

Although the new lease accounting standard, ASU 2016-02, Leases (Topic 842), is not effective until 2019 for public entities or 2020 for nonpublic entities, now is the time to have a game plan defined and in motion. With over 1,000 pages to this new standard, including conforming amendments to other topics and background information, the intent of this article is not to dwell on the requirements but rather to point out planning and implementation considerations. These considerations relate to contract reviews, loan covenants, training, change efforts, adoption, and stakeholder communications. This new standard will likely have broad internal impacts on operations, tax, treasury, legal, technology, budgeting, contract management, and regulatory reporting. It is important to grasp these impacts now to be best prepared.

Brief Overview of ASU 2016-02

Leasing has been an important avenue for a 'lessee' to access and use real estate, equipment, automobiles and other depreciable assets legally owned by a 'lessor,' and pay over time. That part is not changing. However, new terminology, accounting, and disclosures from this standard run deep, especially for lessees. No longer can today's operating lease avoid the lessee's balance sheet unless it is 12 months or less in duration and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. Lessees will now need to recognize both an asset and liability for traditional operating leases unless they are short-term. In essence, balance sheets will be grossed-up as these historical off-balance sheet leases will now need to be captured. Although the lessor accounting side is substantially unchanged, the classification of a leveraged lease is eliminated. In addition, increased disclosure requirements will impact both the lessee and the lessor.

Despite a ten year effort since the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) first identified leases as a joint project in 2006, the two boards did not agree to use the same model. The IASB launched a single model for all leases per IFRS 16 (released in January 2016), while the FASB decided upon a dual model for lessees of either classifying leases as a finance lease or an operating lease. In addition, FASB will now require lessors to classify a lease as either a sales-type, direct financing, or operating lease.

Recognition and Measurement under the New Standard

At the lease commencement date, the lessee recognizes a right-of-use asset and a lease liability. The lease liability is measured at the present value of the unpaid lease payments. The right-of-use asset is the amount of the initial lease liability plus any lease payments made to the lessor at or before the commencement date less any incentives received, plus any initial direct costs. After the commencement date, the lessee recognizes the following in their profit or loss based on the type of lease:

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Finance Lease (most leases of assets other than property):

- Amortize the right-of-use (ROU) asset and interest of the lease liability separately. The lease liability is reduced by the amount of the periodic lease payment less the amount recognized as interest expense for the period. The ROU asset is generally amortized on a straight-line bases over the useful life of the asset to the lessee.
- Estimate changes to applicable variable lease payments not included in the lease liability in the period the obligation incurred.
- Test the right-of-use asset for impairment in accordance with ASC 360.

Operating Lease (most leases of property, such as land and/or buildings):

- Record lease expense on a straight-line basis over the lease term as a single cost, unless another allocation method is more representative of the benefit from the asset. The lease liability is reduced by the amount of the periodic payment less the amount of that payment attributable to interest using the effective interest method, while amortization of the ROU asset is the difference.
- Estimate changes to applicable variable lease payments not included in the lease liability in the period the obligation incurred.
- Test the right-of-use asset for impairment in accordance with ASC 360.

For lessors the accounting at the commencement date and afterwards will depend on the type of lease. Here are some key aspects:

Sales-Type Lease	Direct Financing Lease	Operating Lease
	At the Commencement Date	
Derecognize the underlying asset and record the net investment in the lease, which is the sum of the present value of the future lease payments and unguaranteed residual value	Derecognize the underlying asset and record the net investment in the lease, which is the sum of the present value of the future lease payments and unguaranteed residual value	The underlying asset remains on the balance sheet and continues to be depreciated over its useful life, which could extend beyond the lease term
Recognize the selling profit or loss arising from the lease	Selling profit is deferred and selling loss is recorded	Not applicable
Recognize initial direct costs as an expense	Initial direct costs are deferred and included in the net investment in the lease	Initial direct costs are deferred and amortized against lease income over the life of the lease
	After the Commencement Date	
The net investment in the lease is accreted, and increased by interest income and decreased by payments collected	The net investment in the lease is accreted, and increased by interest income and decreased by payments collected	Recognize lease revenue and depreciation expense on a straight-line basis, unless another allocation method is more representative of the benefit from the asset
The unguaranteed residual value of the asset is accreted and increased to its estimated residual value	The unguaranteed residual value of the asset is accreted and increased to its estimated residual value	Not applicable

There are many additional accounting and disclosure requirements, so it is best to reference ASU 2016-02 directly, discuss it internally and with your auditors, and design an implementation plan. Important planning and implementation considerations include:

1. **Review all contracts to take an inventory of leases**: Under ASC 842, a lease is defined 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 the right to obtain substantially all of the economic benefits from the use of the asset, and the right to direct the use of the asset. It will be important to identify all leases from contracts and gather new information necessary for proper accounting and disclosure treatment. New information requirements include the implicit rate in the lease, and if that is not determinable, the incremental borrowing rates for operating leases. This effort can be significant.

2. **Consider renegotiation of loan covenants**: Early discussions by lessees with their banks can be beneficial to renegotiate loan covenants to potentially exclude, or minimize, the impact of this new standard on covenant requirements.

3. **Conduct early and on-going training**: The new lease accounting standard will require significantly more judgments and reassessments, which will likely lead to additional risk points and the need for more robust controls. Accounting modules within ERP systems will also likely need to be modified, as well as the chart-of-accounts, and communication channels. These factors, among others, will trigger the need to reassess existing capabilities and skill-sets. Regardless of how prepared a company feels they are now, there will certainly be new training, supervision, and coaching needs, especially around expanded judgments. Also be sure to keep in mind educational needs of the board, audit committee, and management.

4. **Don't under estimate the change effort on leasing systems, processes, objectives, risks, and controls**: There will likely be a significant ripple effect throughout the organization. Work early to identify impacts, understand them, and incorporate how they will be addressed in an implementation plan. This will entail deep internal communications and coordination with legal, IT, tax, operations, treasury, internal audit, investor relations, and procurement.

5. **Consider adoption concurrently with the new revenue recognition standard – ASC 606**: The FASB allows early adoption of the lease standard, so a decision must be made to either adopt the lease standard after the new revenue standard, or adopt the two standards concurrently. While there are pros and cons to implementing the two standards at the same time, for lessors the two standards are closely aligned so a concurrent adoption likely makes sense.

6. **Identify and execute communication plans with key external stakeholders**: The lessee's balance sheet is going to look much different. Disclosures will also be significantly expanded, and judgments will need to be explained for the lessee and lessor. For lessees, the impact could be dramatic on non-GAAP financial measures, debt covenants, tax impacts, and wide range of ratios traditionally reported to investors, creditors, and analysts. No one likes surprises, so it will be important to educate stakeholders of the changes well in advance of them seeing the newly adopted standard in action through the financial statements and other communications.

In conclusion, don't let the effective date of this important new accounting standard lull you to sleep. Now is the time to have a thorough game plan defined and in motion. Ensure that adequate resources are in place for successful implementation.

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Ron Kral is the Managing Partner of Candela Solutions LLC, a public accounting firm with a national focus on governance, SEC compliance, and internal auditing. He is an educator, advisor, and internal auditor for boards and management teams. Ron is a member of 4 of the 5 COSO sponsoring organizations; the AICPA, FEI, IIA, and IMA. He can be reached at rkral@CandelaSolutions.com, or you can connect with him at www.linkedin.com/in/ronkral.

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