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A new era for lease accounting

YOUR BALANCE SHEET MAY NEVER LOOK THE SAME

Overview

On February 25, 2016, the Financial Accounting Standards Board (FASB) issued new guidance that will have far-reaching implications for how leases are reflected in the financial statements of entities in nearly every sector of the economy. Leases are one of the most popular forms of asset financing, in no small part due to the ability in many situations to structure the arrangement to keep lease obligations off the balance sheet.

The new standard was originally part of a joint effort between the FASB and the International Accounting Standards Board (IASB) to improve lease accounting, while also further converging U.S. generally accepted accounting principles (U.S. GAAP) with the International Financial Reporting Standards (IFRS). While the two boards successfully issued a joint standard on revenue recognition in 2014, they were unable to come to a similar agreement on lease accounting, and ultimately elected to issue separate lease standards (the international lease accounting standard was issued in January 2016). The new U.S. standard, titled simply *Leases*, follows more than six years of work and numerous outreach sessions to gather feedback from key stakeholders prior to finalizing the standard. The new guidance affects the accounting for both lessees and lessors in a leasing transaction.

Lessee accounting

The most significant change in the new standard is the requirement for lessees to report lease obligations on their balance sheet, with few exceptions. Historically, leases have been classified as either capital leases or operating leases, with only capital leases recorded on the lessee's balance sheet. Under the new standard, there will continue to be two types of leases, finance leases and operating leases; however, both finance leases and operating leases will be recorded on the lessee's balance sheet. When an entity enters into a lease arrangement, it will record a liability for the future lease payments, along with an asset representing its exclusive right to use the underlying leased asset over the term of the agreement. The new guidance contains an exception for short-term leases, which are those with a maximum lease term of 12 months or less (including any renewal periods). Short-term leases will not be recorded on the balance sheet, but rather will be accounted for similarly to operating leases under current U.S. GAAP.

The criteria for differentiating between finance leases and operating leases is similar to the current guidance used to classify leases as capital or operating. It is expected that most leases currently classified as capital leases will be considered finance leases under the new standard, and most leases currently classified as operating leases will continue to be treated as such under the new guidance. While both types of leases will be recorded on the balance sheet, there is a difference in the way lease expenses will be recognized in the income statement.

Finance leases vs operating leases — Finance leases under the new standard are similar to capital leases under current U.S. GAAP. They are viewed as a type of financing with expense recognition similar to loans and other debt. Interest expense for finance leases will be recognized over the lease term similar to a loan, with amortization of the asset based on the entity's policies for other long-lived assets. This method results in higher amounts of lease expense recognized early in the life of the lease, and lower lease expense in later years due to the declining balance of the liability over time. This expense recognition pattern was one of the more controversial aspects of the new lease standard, and ultimately resulted in the split between the U.S. and international versions of the lease guidance. To alleviate concerns over expense recognition for leases that have historically been classified as operating leases, the FASB in the new guidance will continue to permit straight-line recognition of expense over the term of the lease for operating leases.

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Lessor accounting

Under the new standard, there will be comparatively fewer changes for lessors, and lease accounting will continue to be largely consistent with existing U.S. GAAP. However, one change that will be made is that lessors now will be required to assess the collectability of lease payments under the new standard.

Other topics

Related party leases — The new standard also changes the accounting for related party leases. Under existing accounting standards, an entity is required to account for leases between related parties based on the economic substance of the transaction, even if it differs from the terms of the agreement. Under the new standard, leases between related parties will be based on the legally-enforceable terms of the agreement. This may provide planning opportunities for entities involved in leasing arrangements with related parties.

Sale and leaseback transactions — Sale and leaseback arrangements, whereby an entity sells an asset to another party and concurrently leases it back, are common in many industries. The new standard changes the rules for sale and leaseback transactions by tying determination of whether a sale has occurred to the new revenue recognition guidance. If the transaction qualifies as a sale, then the leaseback should be evaluated the same way as any other lease transaction by both the seller-lessee and buyer-lessor. If a transaction fails to qualify as a sale, the new guidance requires the arrangement to be accounted for as a financing transaction.

Effective date and transition

The new lease guidance will be effective for public business entities for periods beginning after December 15, 2018 (2019 for calendar-year entities), with private companies and other entities provided a one-year deferral until periods beginning after December 15, 2019 (2020 for calendar-year entities).

The standard requires a modified retrospective application approach, which will shorten the time frame for implementation. For example, for companies initially applying the new guidance in the first quarter of 2019, retrospective application would be required for the comparative quarter in 2018.

Planning for transition

With a three to four year implementation time frame, it may seem early to begin planning for the transition. However, many lease contracts cover periods of three to five years or longer, and the new standard requires existing leases to be transitioned to the new rules at implementation. In addition, many lessees that have historically structured lease arrangements as operating leases may begin to recognize significant lease obligations in their financial statements. As a result, entities should begin to plan for the effects of the new standard. Some actions that should be taken during 2016 include:

Understanding the new lease classification requirements — Accounting and finance staff will need to develop a thorough understanding of the key principles for determining how a lease is classified. In addition, individuals responsible for negotiating lease agreements will need to gain an understanding of the standard so that new lease agreements and renewals of existing lease agreements take the new accounting standards into consideration.

Review existing lease contracts — The new lease standard will require nearly all leases to be recorded on the balance sheet based on the terms of the lease agreements. Reviewing existing contracts will be necessary to quantify the effects of implementing the new standard.

Consider changes to systems and internal controls — The new lease guidance will require more information to be gathered to recognize and disclose lease arrangements in the financial statements. Information systems will need to be evaluated to determine whether they can provide the necessary data, and the related internal controls may also require modification.

Consider other impacts on the business — Given the significant impact that is expected when the new standard is implemented and additional leases are required to be recorded on the balance sheet, it's likely that numerous other areas will be affected. Some of the most common include:

- **Financial metrics.** Key financial metrics communicated to investors, lenders, and others will likely be affected

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as more leases will be recorded on the balance sheet. Communication of the changes in advance will be required.

- **Debt covenants.** Many debt covenants are affected by ratios that are likely to be impacted by having additional leases recorded on the balance sheet. Changes to covenants may be required in advance of adopting the new standard.

- **Lease vs. buy decisions.** The new lease guidance may influence how entities evaluate lease vs. buy decisions, taking into account the elimination of off-balance sheet financing available under current U.S. GAAP.

Communicate with key stakeholders — As with all significant accounting changes, communication of the expected effects on the financial statements to key stakeholders (management, investors, audit committee, lenders, and others) is critical.

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How Plante Moran can help

Contact your Plante Moran adviser to discuss the specifics of your transition plan. We have the right accounting, tax, and consulting specialists to make sure you're prepared for the change on your timetable. For additional information, please contact:

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