How Leasing Standards Will Change Under the New FASB Requirements
Traditionally operating leases were mere footnotes in the financial statement, with limited impact on the liabilities assessed by investors and potential creditors.

The ASC 842 rules from the Financial Standards Accounting Board change all of that: As of January 1st, 2019, the right to use the leased asset is recognized as an asset side item—meaning companies need to marshal their resources and technology to incorporate the new disclosures.

Is your company prepared to ensure compliance and to mitigate risk under these standards?
**The impact on your balance sheet**

While on the surface this might seem like a simple change in accounting, the implications of ASC 842 for many companies are potentially serious.

The additional balance sheet liabilities may not only put your company in violation of your loan covenants for existing debt, but also affect a number of your company’s financial ratios.

These include:

- **The current ratio:** The increase in short-term liabilities (i.e. the lease payments) will decrease this ratio
- **Debt to equity ratio:** This ratio could decrease with the inclusion of the total value of the lease as a long-term liability
- **Debt service coverage ratio:** The inclusion of the operating liability without an offsetting cash flow item could distort this ratio going forward

While the implications for the balance sheet are clear, the implications for a company’s P&L statement may be less apparent. Many lease-related costs will remain the same.

**Process and system changes to consider**

The scope and magnitude of the changes necessitated by ASC 842 will naturally vary by company. In some cases, meeting the new reporting requirements will require a significant overhaul in these processes and systems.

Generally speaking, accounting departments are often well-versed in accounting and finance, but less so in lease issues.

Here is a small sampling of the types of data and information that will need to be understood in a post-ASC 842 environment:
Lease payment information from the lease document will generally only spell out the aggregate monthly payment amount. However, the ASC 842 rules require that the base lease payment be accounted for separately from any applicable taxes, insurance or maintenance.

Future intentions of the lessee must also be accounted for under the new rules. If the intention is to end a lease early or to exercise a purchase option for the asset at the end of the lease—if applicable—both eventualities will impact the way the lease liability is accounted for on the balance sheet.

Though it may sound simplistic, a great first step in the data gathering process is simply to round up and organize all relevant documents pertaining to leased assets. These may be in paper form or on your company system and may—in the case of more complex leases—extend beyond the basic leasing agreement to multiple addendums and other supplemental parts of the agreement.

If you believe you are missing portions of the lease agreement, don’t hesitate to reach out to the lessor to ensure you have the complete lease document. After all, it’s in the best interests of the lessor that your company be compliant—and able to make payments.
Review and update your lease accounting procedures

ASC 842 reporting requirements are expected to cast more attention on how companies handle all aspects of the leasing process from negotiation to implementation to termination.

Depending on your timelines, it may be necessary to implement provisional or temporary systems to be ready sooner, then implement long-term changes for consistent reporting going forward.

Further, there is a transitional reporting element of ASC 842, which requires comparative financial statements for a two-year period showing results under both the old lease reporting rules and the new rules.

It is a best practice to document these and other processes to create uniformity in the handling of each lease going forward. Ideally these new processes will become standard operating procedures throughout all impacted areas of the company. Finance is the logical part of the company to spearhead these efforts, but every effort should be made to bring all areas of the company on board.

Review and update your internal controls and analysis pertaining to leases

So how can you build proper internal controls and analysis surrounding leases into the culture of your company?

First, analyze the vendors who serve as lessors for various types of assets: Is there a concentration with certain asset types such as equipment, real estate, or vehicles?
Then analyze lease discount rates by lessor, by asset type, or other identifier.

Finally, analyze the disposition of leased assets: Is action taken on leased assets upon expiration or are certain types of assets routinely held for usage after the expiration date of the lease?

This process can yield vast amounts of information which may be used to define and implement procedures surrounding the leasing of assets.

These could potentially include:

- Improved criteria to select lease vendors for specific asset types
- Target discount rates and lease terms for specific asset types
- Measures to ensure lease terms for various types of assets reflect the time frame for which they are typically needed

Most importantly, data and analysis can lead to a uniform set of criteria and processes for procuring assets via leases and approving the lease terms.

**The legal criteria for leases and lease payments**

Determining if a contractual arrangement can be legally designated as a lease in the first place can get surprisingly complex.

According to the FASB, 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 for a period of time in exchange for consideration.
Determining who has control of the asset is where qualification issues usually surface. The following questions can help you make the appropriate determination:

- Is there a leased asset that can be specifically identified?
- Does the company have the right to obtain substantially all the economic benefits from the use of the asset for the term of the contract?
- Who has the right to direct the use of the asset in terms of how and for what purpose the asset is used over the term of the contract? The company or the lessor?
- Do you have the right to operate the asset throughout the period of the contract without the supplier having the right to change the operating parameters?
- Did you design the asset—or substantial portions of the asset—in a fashion that clearly predetermines how the asset was to be used during the period of the contract?

There will also be some differences in which lease costs will be capitalized under the new ASC 842 standards.

While costs associated with leasing an asset—such as insurance and property taxes—were previously not capitalized, those expenses going forward will be included in the liability for lease costs and the asset representing the use of the item.

Depending upon the type of lease, the following expenses could potentially be included in lease payment calculations:

- Fixed lease payments
- Certain variable lease payments
- Purchase options if applicable
- Termination penalties
- Fees paid to the lessor to structure the transaction
- Residual value guarantees

The configuration matters because the costs which are ultimately included will determine the proper balance sheet classification of a given lease as well as the compliance and accounting rules to be met.
Changes to the sale-leaseback terms and conditions

In a sale-leaseback transaction, a company sells an asset such as a piece of equipment to another party and then leases the asset back from that party. Which is to say, the company gets cash upfront and then makes lease payments to the lessor.

A sale-leaseback can make sense to a seller for any number of reasons—from cash flow issues to an inability to fully utilize depreciation on the asset.

Under ASC 842 rules, this type of transaction will be considered a failed transaction and classified as debt financing.

To be designated a true sale-leaseback transaction in a post-ASC 842 environment, the following conditions will need to be met:

- The transfer of the underlying asset to the other party must meet the definition of a sale under a new revenue standard which defines revenue recognition from contracts with customers. Is there a contract between the parties? Has control of the asset been transferred to the other party? The answers to these questions will be paramount as you make this determination.
- Does the sale-leaseback arrangement result in a lease that would be classified as a sales-type lease or a finance lease? In either case, the company essentially transfers ownership of the asset but still maintains control of it. This may disqualify the transaction from being called a sale-leaseback arrangement.
- Does the agreement contain a repurchase option?

If yes, it will not qualify unless:

- The repurchase option is exercisable at the then-fair market value of the asset, and
- Substantially similar alternatives to the asset are available in the marketplace at the time the option is exercised.

If these criteria are all met, then the transaction can be accounted for as a sale-leaseback transaction under the ASC 842 rules.
Expanded financial statement disclosures

According to the Financial Times, there are some $3 trillion in off-balance sheet lease commitments across the globe. Often these commitments—as well as some related details—are disclosed in the unaudited management discussion section of a company’s financial statements or in statement footnotes.

ASC 842 significantly increases and upgrades both quantitative and qualitative disclosures for lessees and lessors. While many of these disclosures were required under the current ACS 840 rules, this mandate extended only to capital leases and not to operating leases. Adding these disclosures for all leases regardless of lease classification is a significant shift under ASC 842—one that calls for attention and preparation.

Qualitative disclosures include:

- Information about the nature of the leases
- Information about leases that have not yet commenced, but that will provide significant benefits obligations for the lessee
- Information about assumptions and judgments including:
  - Determination as to whether the contract is a lease
  - The allocation of consideration provided by the lessee between lease payments and non-lease payments
  - The discount rate for the lease and how it was determined
- All terms and conditions of a sale-leaseback arrangement
- Lease transactions between related entities
- Whether the company has an accounting policy for the short-term lease exemption
Quantitative disclosures include:

- The finance lease cost segregated between the amortization of the right-to-use asset and the interest on the lease liability
- Operating lease costs
- Short-term lease costs, with an exception for leases with a term of one month or less
- Variable lease costs
- Any net gain or loss recognized in a sale-leaseback transaction
- A maturity analysis of all lease costs for the five years subsequent to the date of the balance sheet and in aggregate for leases maturing after that time. (Also, a reconciliation of the undiscounted cash flows from leases to the lease liability reflected on the balance sheet is required.)
- Amounts segregated between operating and capital leases for the following items:
  - Cash paid for the amounts included in the lease liabilities reflected on the balance sheet—again segregated between operating and financing cash flows
  - Noncash information arising from obtaining right-of-use assets
  - The weighted average aggregate remaining lease term of all leased assets
  - The weighted average lease discount rate
How this could change your lease versus purchase decisions

With all these coming changes in lease accounting, it’s instructive to take a step back and examine how these changes might influence a company’s decision to lease or buy an asset.

Every company’s situation is different and this decision should be analyzed on a case-by-case basis.

That said, the benefits of leasing will still largely remain in place even with these rules.

These include:

- No down payment is required and the asset can generally be put into service quickly
- The company can use its capital elsewhere
- Lease payments and terms can usually be tied to the asset’s useful life
- Disposal of the asset is the responsibility of the lessor at the end of the lease term
- For assets like computers or others where technology changes quickly, leasing can be a hedge against obsolescence
- The lease terms may be better than financing terms on a loan
- An alternative for companies that may not be in a financial position to fully take advantage of the deductions for depreciation or the section 179 deductions
The opportunity for improvement

Compliance with FASB ASC 842 will precipitate revisions and even an overhaul for many companies, but the information and data gathered in the process can be leveraged to improve a company’s policies on leasing, including preferred vendors and arrangements.

If approached with the right mindset and appropriate degree of forethought, this evolution could potentially be tailored to the needs and resources of your company in ways that not only minimize compliance disruptions, but also provide holistic and wide-ranging benefits to your overall operations.

Sources:


https://www.gaapdynamics.com/insights/blog/2017/04/19/lease-disclosures-stepping-it-up-from-asc-840-to-asc-842/


https://www.elfaonline.org/docs/default-source/industry-topics/accounting/leaseacctingleasebuydecisionqb07132016.pdf?sfvrsn=0