Audit committee spotlight: Getting ready for lease accounting changes

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As part of its governance responsibilities, the audit committee must ascertain that the organization's management team has a sound plan for implementing any new and relevant accounting standards. Upcoming changes to the FASB's lease accounting guidance promise to affect a wide range of organizations, particularly lessees, but also lessors. Plans to assess the expected impact on the organization and how to implement the new standard should therefore be on the agendas of many, if not most, audit committees.

The new standard is required for all leases, except those specifically excluded, such as certain leases involving intangible assets, natural resources, inventories and assets under construction. It goes into effect for public companies in fiscal years beginning after Dec. 15, 2018, and for private companies in fiscal years beginning after Dec. 15, 2019. Early adoption is permitted for all entities. The relevant FASB guidance is Accounting Standards Update 2016-02, which is codified as Accounting Standards Codification (ASC) Topic 842 and replaces ASC Topic 840. For more details on the new lease accounting standard, see New Developments Summary: FASB Issues New Lease Accounting Standard.

While the effective dates may still seem far off to some, the new standard will affect financial statements and internal accounting and, for many companies, future lease negotiations, administration and budgeting. In other words, it presents a number of issues for audit committees to discuss with management to ensure that the organization understands the impact, is prepared for adoption and can implement it smoothly.

This document, authored by a former FASB member involved in establishing this accounting standard (among others), aims to prepare audit committee members for discussions on the new lease accounting standard with management, internal audit and other relevant parties.

Primary intent of the new standard

Essentially the new standard aims to recognize a lessee's financial obligations under lease agreements on the balance sheet. The distinction between operating and capital (finance) leases will continue under ASC 842. Also, lease elements embedded in service agreements may be subject to reporting on the balance sheet.

Lessees with substantial lease obligations may therefore be adding significant amounts to their balance sheets. The impact on lessors will be less significant — another intent of the change. The FASB did consider a mirror-image approach in which the accounts of lessees and lessors would, so to speak, balance in the aggregate. Yet, given the primary intention of more accurately reflecting lessees' financial obligations, the FASB decided to leave lessor accounting essentially as it was, with minor changes primarily intended to align with the FASB's new revenue recognition guidance under ASC Topic 606. Lessors may, however, be affected by lessees seeking to structure their leases differently in this new accounting environment.

4 things to know

The following concepts are central to understanding the new standard and its potential impact on your organization:

1 Defining leases

The new standard defines a lease as a contract or part of a contract that transfers the right to control the use of the underlying asset for a period of time for consideration. Under the new standard, a contract will be considered to be or contain a lease when the customer has both the right to substantially all of the economic benefits of the use of the asset and direct the use of the asset. Perhaps the most significant impact of the new definition is that it will no longer cause a contract to be deemed to contain a lease simply because the customer is taking substantially all of the output from a particular asset. In addition, the new standard will narrow the definition of "initial direct costs" to include only the incremental costs that the lessee would not have incurred had the lease not been executed.

2 Separating lease and nonlease components

Many lease agreements have a service component, e.g., for maintenance of leased equipment or space. Under the new standard, the service component would likely represent an expense rather than an amount to be capitalized and shown on the balance sheet. By the same token, components meeting the definition of a lease would have to be isolated, accounted for separately and shown on the balance sheet.

For example, a maintenance agreement that covers the use of a piece of equipment that is unique to your company and has no alternative use to the service provider could potentially be considered to contain a lease under the new standard, which would require separate accounting. Prior to implementation of the new standard, the accounting requirements for service contracts and operating leases are essentially identical, so companies may not have focused on the lease versus nonlease distinction. However, the balance sheet treatment of the lease component under ASC 842 emphasizes the need for such focus.

Notwithstanding the above, the new standard provides a practical expedient for lessees with regard to separating lease components from nonlease components. Lessees may make an accounting policy election by class of underlying asset not to separate lease components from nonlease components. If an entity makes that election, it is required to account for the lease and nonlease components together as a single lease component.

3 Making the transition

The FASB recognized that lessors and lessees might struggle with the modified retrospective transition approach due to the extent of their leasing activities, so there are several transition reliefs in the final standard. Lessors and lessees can elect — but only for all leases — not to reassess the following upon transition:

- Whether any expired or existing contracts are or contain leases
- Whether to change the classification of any expired or existing leases
- Whether initial direct costs for any existing leases qualify for capitalization under the new standard

As a separate transition relief, both lessors and lessees may — again, for all leases as a package — use hindsight in determining the lease term with respect to renewals and purchase options, and in evaluating the right of use associated with the asset.

As organizations plan their transitions, they should consider whether they intend to use any of the transition reliefs and plan their activities accordingly.

4 Understanding the FASB and IASB standards

For companies following U.S. GAAP, the FASB standard will be applicable. However, the IASB has also issued a new lease accounting standard applicable to companies following International Financial Reporting Standards (IFRS), which differs from the FASB model. Most significantly, the IASB classifies all leases as finance leases. The boards' final standards differ primarily because their respective stakeholders provided significantly different feedback about the drivers of cost and complexity in the earlier proposals and the changes the boards should make to address those drivers.

3 things to do

In light of these changes, audit committees should ensure that the following considerations and activities have been addressed by their organizations:

1 Review the administration of leases

If your company has been negotiating leases and accounting for them on a decentralized basis, it would be useful for management to review those practices. It makes sense for companies to control and monitor operating leases at the level of the business unit or function when they are classified and treated as an expense along the lines of service agreements. However, going forward, these leases will be on the balance sheet as assets and liabilities.

In light of this, companies with significant lease obligations may choose to centralize that function for accounting, control and perhaps negotiating purposes. In the absence of more centralized processes, it may be wise to establish or enhance processes for capturing all needed information when new leases are signed. The goal is to ensure that leases are appropriately accounted for on the balance sheet, as well as on the income statement.

2 Separating lease and nonlease components

The impact of the new standard — and the effort it will take to adopt it — depends on your organization's volume of leases and current treatment of leases. Retailers or wholesalers that lease space over various locations under contracts that have been classified as operating leases will have to bring them onto their balance sheets. In addition, companies in equipment-intensive industries — such as health care, transportation or construction — and that lease their equipment could have thousands of agreements to evaluate, particularly if there are service components embedded in those agreements.

On the latter subject, management may want to structure future service agreements that meet the definition of a lease under the new standard in ways that make it easier for the two components to be identified and measured.

3 Ensure that a plan for adoption is in place

The organization needs a plan for adopting the new standard to keep up with the number and type of leases it will have to address. Potential complexities include separating lease and nonlease components and applying the modified retrospective transaction approach, as noted above. Other potential complexities include analyzing lease agreements covering multiple assets with numerous components, as well as the lease renewal options, likelihood of renewal and resulting overall lease term — each of which may affect the amount to be placed on the balance sheet.

Companies might expect increased internal and external audit attention to the completeness and accuracy of the underlying data and calculations because of the new balance sheet's impact on operating leases. This will heighten the pressure on organizations to appropriately apply the new definition of a lease. Organizations that have a planned and well-documented approach to identifying all lease components and validating the information used in the calculations and disclosures will be in a good position for any additional scrutiny.

Legacy accounting systems that do not identify and track various lease components and amounts can present significant work associated with lease structure analysis, data extraction and accounting system adjustments. In addition, to the extent that a lessee lacks the information needed to separately account for lease and nonlease components, it may need to obtain that information from the lessor. The implementation plan should definitely consider such factors.

The plan should also provide for a cross-functional team with representation, as needed, from finance, accounting, tax, operations, legal, IT, internal audit and, for public companies, possibly investor relations. Allow sufficient time and resources to address unexpected findings as leases are analyzed, and to change the ways in which leases are administered. Also, involve your external auditors sooner rather than later. After consultation with them, prepare your approach, gauge the potential impact on the financial statements and ascertain that the external auditors are in agreement with your approach to and treatment of the leased assets.

The time is now

Public companies with a substantial number of leases to analyze and account for under the new standard should have a plan and a process for adoption in place by now. This means having the implementation team lined up, with all key players familiar with the standard, its impact on the organization and their roles in the implementation. Key team members should also be discussing your organization's approach to adoption with your external auditor, if applicable.

Additionally, your organization should have a good idea of the budget and resources that implementation will require, including the tasks you will be able to execute internally and those you will need external resources to support. In addition, work needed to develop, acquire or access models to assist in gauging the potential effects of different accounting treatments should begin soon if it is not currently underway.

If your organization has had a team working on adoption of the new revenue recognition standard, you may have a good idea of the effort that a new accounting standard demands, the resources needed and issues that may arise. Our own experience and that of our clients strongly indicates that detailed planning, adequate resourcing, and generous lead times are the key factors in smooth and advantageous implementation of any new and far-reaching accounting standard.

AUTHOR'S BIO NOTE

Daryl Buck is the managing partner of Grant Thornton LLP's Accounting Advisory Services practice. He has more than 30 years of public accounting and financial leadership experience, including more than five years serving as a member of the FASB, where he worked to establish and improve GAAP for the United States and also sought to coordinate them with IFRS. Prior to being named to the FASB, he served as senior vice president and CFO for Reasor's Holding Company Inc. Early in his career, Buck was an audit manager for Arthur Andersen LLP.

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