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Leasing

Identifying a Lease Will Be Hardest Part of Lease Accounting

Companies planning on adopting the new lease accounting rules should be aware that the accounting isn't the toughest part of applying the rules—it's determining the total number of leases that might be embedded as part of a contract.

''The hardest part of adopting the leasing standard is not figuring out the accounting entries for the leases you know about, it's figuring out the total population of what are leases,'' Deloitte & Touche LLP chairman and chief executive officer Joseph Ucuzoglu said June 12 at a Practising Law Institute financial reporting conference.

An example would be a company that has historically entered into an information technology (IT) outsourcing contract, Ucuzoglu said. ''So there's some other entity out there that goes out, they buy the computers, the servers, they house the people that fulfill IT services for the corporation and it's done under a four-or five year contract.''

Companies that utilize managed cloud services from data center providers, such as Perot Systems, now owned by NTT Data Corp., RapidScale or Evolve IT are good examples that would fit Ucuzoglu's fact pattern, particularly in scenarios where they provide dedicated servers to a company, a practitioner told Bloomberg BNA.

It may well be that embedded in that contract is essentially a lease because all of the computer equipment and all of the servers have been purchased on behalf of the company, and they are solely dedicated to be used by the company.

An embedded lease occurs when an explicit or implicit asset is in a contract, and the customer controls use of the asset.

Once an embedded lease is spotted in a performance obligation, the contract has to be divided into its lease and nonlease components and accounted for separately, according to the Financial Accounting Standard Board's ASC 842, Leases.

Analysis Isn't Simple ''The analysis isn't simple, because sometimes the outsourced party might actually be able to swap out equipment, use the same equipment for different parties and in that case, it really hasn't been dedicated to one company that's not a lease,'' said Ucuzoglu, who didn't refer to a particular company.

''In the past it probably didn't matter much because whether it was a lease or not you were essentially going to expense the amounts incurred every year through the P&L, nothing would go on the balance sheet because it was relatively short term,'' Ucuzoglu said. ''As for today there is a significant impact in concluding that it is a lease.''

The new lease accounting rules, though effective beginning in 2019, can be adopted earlier. They are one of the biggest changes in financial reporting and are expected to have substantial impacts. The guidance will provide analysts with insight into the liabilities of a company by requiring companies to place on their balance sheets the assets and liabilities they previously kept off balance sheets.

Not only can that number be substantial for some companies, the changes could also affect the financial ratios used by analysts to evaluate companies—for example, the quick ratio and return on assets.

Payment Allocation a Challenge Embedded contracts will be one of the biggest challenges companies face, George Azih, chief executive officer of lease accounting software provider LeaseQuery.com told Bloomberg BNA.

''It's more complex because now you have to divide the payments you made into components and allocate them differently; a portion would be allocated to the leasing component of the contract, others would be allocated to other services, for instance maintenance or utilities,'' Azih said. ''A lot of times the customer doesn't have insight into that so they have to make estimates and judgment calls.''

Another challenge companies will face in adopting the rules, Azih said, is figuring out how to calculate the amount of the liability a company must record on the balance sheet. ''A part of that is determining what the borrowing rate should be for each lease because of the share volume,'' he said. That issue could have major impacts on smaller public companies, which mightn't calculate their borrowing rate frequently.

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