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Preparing for the new lease accounting standard

What automotive companies need to know

Preface

The new lease accounting standard is expected to have a significant impact on companies in the automotive industry. Its main objective is to address concerns about lessees using operating leases as a form of off-balance-sheet financing. To that end, the biggest change is that nearly all leases lasting more than a year will need to be captured on the lessee's balance sheet (even operating leases, which have traditionally been expensed on a straight-line basis with no balance sheet impact for the leased asset or lease liability).

Another significant related change is that companies will need to scrutinize their service contracts for components that are essentially "embedded leases"—and then account for them as such. In the past, it was a common mistake to overlook the embedded lease components of a service contract, treating the entire contract as a service. While this may have resulted in a disclosure issue under the old lease standard, it would not have caused an issue on the balance sheet. However, under the new standard it will be essential to properly separate the lease and non–lease components of a service contract.

Background

This document highlights some industry–specific impacts of the new leasing standard, and provides real–world examples to illustrate how an informed approach to lease accounting can improve a company's decision–making and financial performance. For a more in–depth analysis, see Deloitte's A Roadmap to Applying the New Leasing Standard, or the roadmap executive summary.

In February 2016, the FASB issued Accounting Standards Update (ASU) No. 2016–02, Leases (codified as Accounting Standards Codification (ASC) Topic 842).

ASC 842 introduces a lessee model that brings most leases onto the balance sheet; aligns certain underlying principles of the lessor model with those in ASC 606 (the FASB's new revenue recognition standard); and addresses other concerns related to the current leasing model, which was based on 40–year–old guidance.

In early January 2018, the FASB followed up by issuing a proposed ASU that would amend the new leasing standard to provide entities with practical expedients that would: (1) limit application of the new standard to the most recent period presented (so entities will not have to restate comparative periods), and (2) not require lessors to separate lease and non–lease components when certain conditions are met.

The new leasing standard goes into effect for calendar periods beginning January 1, 2019, for public business entities, and January 1, 2020, for all other entities. However, all entities have the option to early–adopt the new leasing standard at the same time they adopt the new revenue recognition standard.

Impact on lessee accounting

Lessees are likely to be most significantly affected by the new leasing standard. ASC 842 retains the two–model approach to classifying leases as operating or finance leases (formerly, capital leases); however, most leases, regardless of classification type, are recorded on the balance sheet. A lessee may elect, as an accounting policy, not to record leases with terms of 12 months or less on the balance sheet.

When a lessee records a lease on the balance sheet, it will recognize a lease liability based on the present value of the future lease payments, with an offsetting entry to recognize a right–of–use (ROU) asset. A lessee will use a discount rate to determine the present value based on the rate implicit in the lease, if readily determinable, or the lessee's incremental borrowing rate.

Although both operating and finance leases will be recorded on the balance sheet, the expense recognition pattern will differ for each. For an operating lease, a lessee would recognize lease expense on a straight–line basis over the lease term. For a finance lease, the lessee would recognize both interest expense (by using the effective interest method) and amortization expense. Therefore, the lessee would generally recognize greater expense earlier in the life of the lease for a finance lease than for an operating lease.

Impact on lessor accounting

Although the changes to the lessor model are not as significant as those to the lessee model, lessors should not underestimate the ASU's potential effect on their financial statements and disclosures. Most importantly, the profit recognition requirements under the lessor model are aligned with those under the FASB's new revenue recognition requirements, and the lease classification criteria have been amended to be consistent with those for a lessee. The ASU requires a lessor to classify a lease, at its commencement, as a sales–type lease, direct financing lease, or operating lease on the basis of the classification criteria in the standard.

Disclosure requirements

The new standard also significantly expands the required lease disclosures. Entities should consider these increased disclosure requirements early in their implementation efforts to ensure they are prepared.

Impact on the automotive industry

The new lease standard is likely to have a major impact on companies in the automotive industry, particularly original equipment manufacturers (OEMs) and suppliers (Tier 1 and Tier 2), which tend to rely heavily on supply contracts involving dedicated production facilities. If an entity takes substantially all of the output from a supplier's production facility or dedicated line, and also determines *what, when,* and *how* the product will be produced, generally the associated supply contracts would be considered leases and therefore need to be captured as assets and liabilities on the balance sheet.

Lower tier suppliers and companies in the aftermarket business will similarly need to evaluate their supply contracts, however, these entities may be less affected since their supply contracts are more likely to involve non–dedicated production operations and parts that are not specific to a particular customer or OEM. These companies still need to understand the new lease standard and carefully assess its impact since their situations are less clear cut and will thus require more judgment and accounting expertise in order to make the correct determinations.

What's more, the new lease standard will likely affect companies at every level of the automotive industry in a variety of common business areas, including:

- *Outsourced warehousing.* If a service provider only has one warehouse and an entity obtains 90% or more of its capacity, and makes decisions about what, if, and when items will be stored—the arrangement will meet the definition of a lease, not a service.
- *Traditional operating leases.* Common types of operating leases—such as leases for real estate, equipment, and vehicles—will generally need to be recorded on the balance sheet if their term is more than one year.
- *Embedded leases in services contracts.* If a service provider has vehicles or other plant, property, and equipment (PPE) dedicated to an entity, the associated assets should be accounted for as a lease. This applies to all kinds of services contracts, from logistics and delivery services to custodial services and office equipment.

Getting started

Addressing all of the issues associated with the new leasing standard may require more time, effort, and resources than many business leaders expect. Most large companies will need to identify and gather detailed data on hundreds to thousands of leases and other service contracts. They will then need to inventory, analyze, and account for all of those leases (and embedded leases) before the new standard's effective date, which for public companies is less than a year away. New internal controls may also need to be designed and implemented related to the adoption of the new leasing standard, in addition to complying with the ongoing accounting and financial reporting requirements of the standard.

Nearly all companies will need to deploy new IT systems to store and manage their lease data going forward. Generally speaking, this is not something that can be adequately handled with spreadsheets. Yet the required systems and processes could take many months to implement.

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