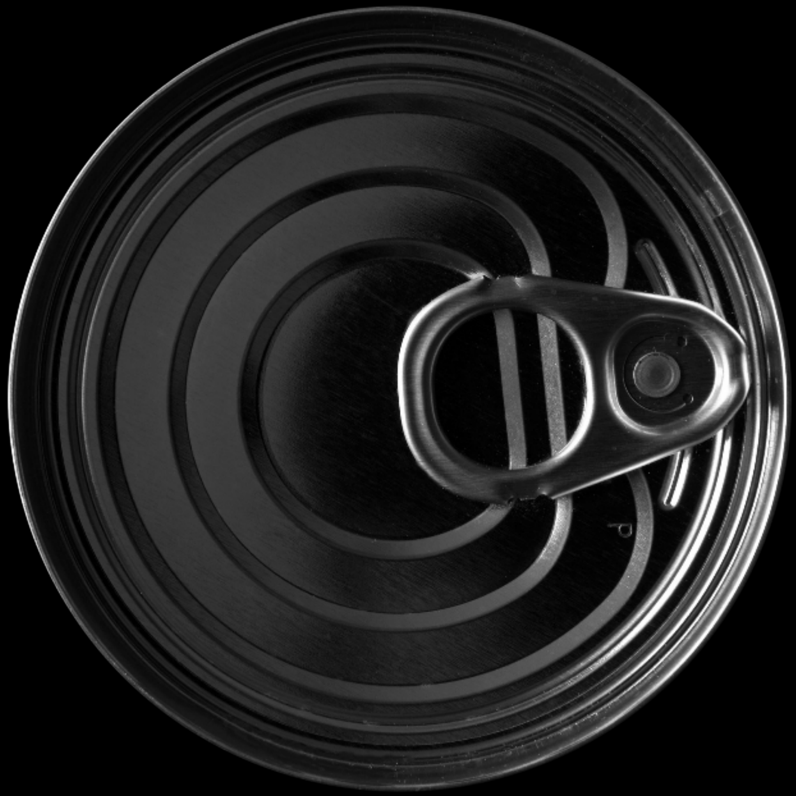


Preparing for the new lease accounting standard

What consumer products companies need to know

Preface

The FASB’s new lease accounting standard, ASC 842 Leases, is expected to have a significant impact on consumer products companies, which produce everything from food and beverages to electronics, apparel, footwear, personal products, and household goods. The change in the new lease accounting standard could have widespread effects.

In implementing the new lease standard, entities will need to change not only their accounting and financial reporting related to leases, but also their related systems and processes. It is important for all entities to develop an implementation plan well before ASU 2016–02’s effective date. Though some of the accounting changes may seem intuitive, the data and systems requirements needed to bring about those changes are significant and, without preparation, may be overwhelming. The new standard’s main objective is to address concerns about using operating leases as a form of off–balance–sheet financing. To that end, the biggest change is that nearly all leases with lease terms of m a year are required to be reflected on the lessee’s balance ore than sheet as a lease liability and corresponding right–of–use asset (even operating leases, which have historically been expensed throughout the lease term). Also, ASC 842 contains new and expanded disclosure requirements that are significantly more comprehensive than those in ASC 840.

Because operating leases will generally be reflected on the balance sheet, it is critical that companies scrutinize their service contracts to determine whether they contain “embedded leases”—which would require all or a portion of the service contract to be accounted for as a lease. For example, consumer products companies enter into long–term agreements for everything from purchasing raw materials to utility services, logistics services, and warehousing. They may also outsource some of the manufacturing of their products. These agreements are papered as services but may fall under leases guidance. Failure to appropriately identify and account for embedded leases under ASC 842 could lead to a material misstatement on the financial statements, whereas failure to appropriately identify and account for operating leases under ASC 840 likely only impacted footnote disclosure of future minimum lease payments.

Background and recent changes

This document highlights some impacts of the new leasing standard that are specific to consumer products companies 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 lessor accounting with those in ASC 606 (the FASB's new revenue recognition standard); and addresses other concerns related to the current lease standard, 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–year–end entities beginning January 1, 2019 (and interim periods therein), for public business entities; and January 1, 2020 (and interim periods thereafter), for all other entities. However, all entities have the option to adopt the new leasing standard early.

Impact on consumer products companies

The new standard is expected to have a significant impact on consumer products companies—particularly beyond the obvious areas such as real estate, equipment, and automobile leases. Here are just a few examples that appear to be service arrangements but meet the definition of a lease in accordance with ASC 842:

- Contract manufacturing. If an entity takes substantially all of the output from a vendor's production facility or dedicated line and also determines what, when, and how the product will be produced, generally those contract manufacturing services would be considered leases.

- Outsourced warehousing. If a service provider only has one warehouse, and an entity obtains 90% or more capacity, and makes decisions about what, if, and when items will be stored, then the arrangement will meet the definition of a lease, not a service.

- Logistics and delivery services. 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. If an entity elects the practical expedient to not revisit whether a contract is or contains a lease under the ASC 842 definition of a lease, the contract would likely meet the definition of a lease only by taking substantially all the output from an asset. Unlike the new lease standard, ASC 840 does not have the requirement of right to direct the use of an asset to meet the definition of a lease.

Impact on consumer products companies

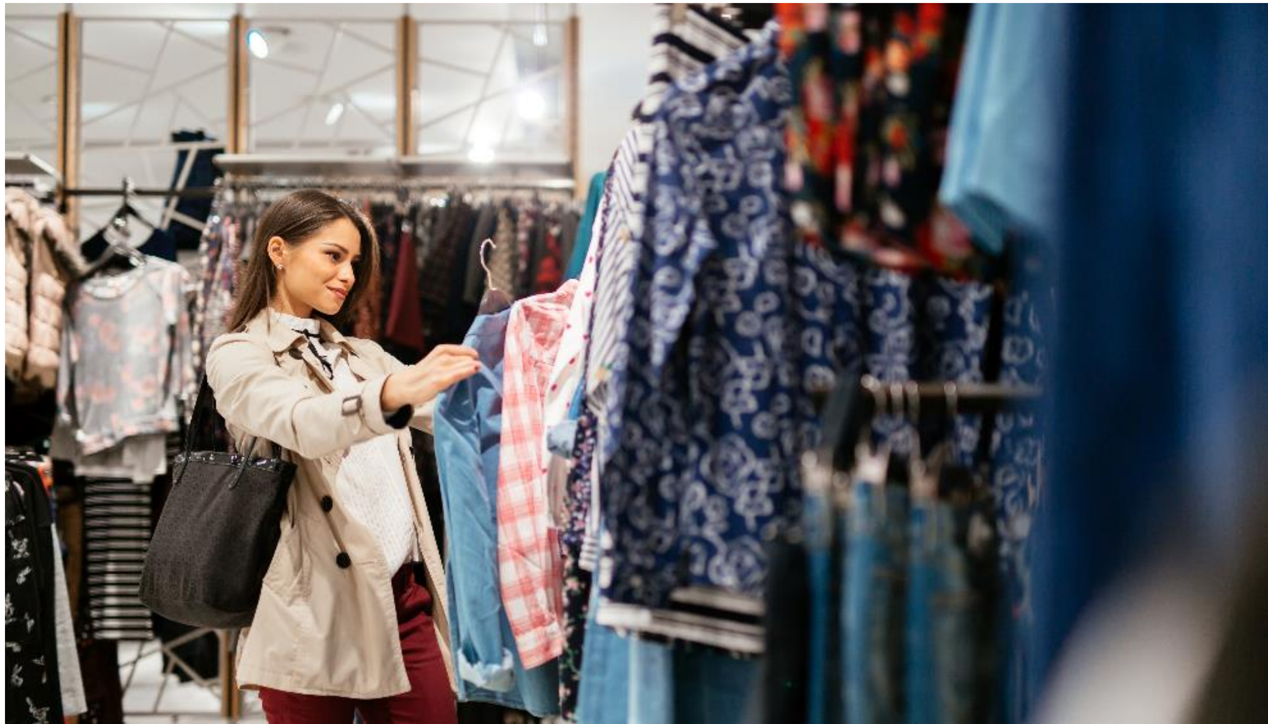
Distribution contract example

Company A enters into a contract with B, a logistics company, to store and deliver up to 1,000 pallets of A's product daily for a 36–month period. The contract requires B to repackage the pallets before delivering to A's customers. B has two storage units that would meet A's requirements. However, one of the units is already being used by another customer of B without the right of substitution.

Throughout the 36–month period of use, A has the right to take products out of, or put them into, the storage unit at any time without B's consent. However, B controls physical access to the storage unit and only B's employees are allowed inside; therefore, B is responsible for physically moving the products as A requests.

A has the right to obtain substantially all of the economic benefits from the storage unit throughout the 36–month period of use because of its exclusive use of the storage unit. Although B controls physical access to the storage unit and is responsible for operating it, B does so according to A's decisions about what products will be stored in the storage unit, if they will be stored, and when. A therefore has the right to direct the use of the storage unit.

Even though the contract is silent about use of the storage facility, fulfillment of the contract depends on an implicit asset. Therefore, the parties have determined that fulfillment of the contract depends on an identified asset. Because A obtains substantially all of the economic benefits from the storage unit (an identified asset) and has the right to direct its use, the contract contains a lease.



Practical expedients may not be very practical

Caution should be applied when electing practical expedients provided in the new lease standard. Improper application of the practical expedients could have financial statement impacts as well as unintended operational impacts. For example, an entity may elect not to separate consideration in a contract between lease and non–lease components to avoid the associated costs and administrative burden. However, electing not to separate lease and non–lease components could result in higher gross up on the balance sheet and could make it more likely that the contract would be viewed as a finance lease.

Considering another example, an entity might elect the practical expedient that allows it not to revisit whether a contract is or contains a lease under the ASC 842 definition of a lease. That is, the entity can carry forward the conclusions reached under ASC 840, even though it might reach a different conclusion under ASC 842. However, in applying this practical expedient, entities may not carry forward any previous “errors” (i.e., incomplete identification of leases). In certain circumstances, for example, an entity might not have previously identified contracts that met the definition of a lease under ASC 840. This lack of identification might not have had a material impact on the entity’s financial statements because the resulting accounting had a similar effect on profit or loss (e.g., an executory contract and an operating lease may have had similar profit and loss profiles). However, since ASC 842 prescribes on–balance–sheet treatment for most leases, the accounting related to properly identifying all leases may materially affect the entity’s financial statements under the new standard. This would make the practical expedient less practical an expedient than it seems for companies that have not historically put an emphasis on assessing their arrangements for embedded leases.

Contacts

Situations like the ones highlighted above could have a major impact on financial statements and the bottom line for consumer products companies. Yet many companies in the industry lack the bandwidth, experience, and expertise to properly apply the new leasing standard. To learn more about how Deloitte can help with your ASC 842 implementation activities, contact:

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