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Preparing for the new lease accounting standard

What retail, wholesale, and distribution companies need to know

Preface

The new lease accounting standard is expected to have a significant impact on retailers, wholesalers, and distributors. 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 adopt the new leasing standard early 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 retail, wholesale, and distribution industry

The new lease standard is likely to have a major impact on retailers, wholesalers, and distributors—especially retailers, which typically have a vast number of operating leases (and potentially leases embedded in service contracts) that will now need to be captured on the balance sheet. Such leases could include everything from real estate leases for individual stores and distribution centers to vehicle leases and office equipment leases. They could also include embedded leases on property, plant, and equipment associated with a service or supply contract.

For example, if a retailer's supply contract requires a dedicated factory for production, that factory might need to be accounted for as a leased asset on the retailer's balance sheet. Similarly, if a retailer contracts with a third party to fulfill online orders from a dedicated facility, the retailer might need to account for that fulfillment facility as a leased asset.

On a more technical level, many retail locations (especially those in malls) have lease contracts with terms that automatically modify under certain circumstances (e.g., co-tenancy clauses). For example, if a mall loses an anchor tenant, the monthly lease payment for a retail location in that mall might switch from a fixed amount to a percentage of sales. Retailers need to identify these modifying contracts, and then figure out how to reflect the modification on their balance sheets.

Retailers also need to understand how the new lease standard will affect their required impairment tests for individual store locations, because having more lease assets on the balance sheet (the ROU asset) could significantly increase the cash flows needed to recover those assets.

The new standard also requires that a lessee account for lease components separate from non-lease components of a contract, unless the election is made to not separate (practical expedient).

Wholesale and distribution businesses will be similarly affected, although on a smaller scale since because their footprint of physical locations and leases is typically much smaller than for retail businesses.

Getting started

Addressing all of the issues associated with the new leasing standard will require more time, effort, and resources than many business leaders expect. Most companies will need to identify and gather detailed data on thousands of leases, which is a huge task in and of itself. They will then need to inventory, analyze, and account for all of those leases and embedded leases before the new standard's start date, which for public companies is less than a year away. New internal controls will need to be implemented during the transition, in addition to ongoing maintenance activities and financial reporting.

Nearly all companies will need to deploy new IT systems to store and manage their lease data. 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.

There is much work to be done, and the clock is ticking. It's time to put the effort into high gear.

Contacts

To learn more about how Deloitte can help with your ASC 842 implementation activities, contact:

RICH PAUL
Partner
US Audit & Assurance Leader, Consumer Industry
Deloitte & Touche LLP
rpaul@deloitte.com

JONATHAN ROTHMAN
Partner
US Audit & Assurance Leader, Retail, Wholesale & Distribution
Deloitte & Touche LLP
jrothman@deloitte.com

BILL PARK
Partner
Professional Practice Director, Retail, Wholesale & Distribution
Deloitte & Touche LLP
bpark@deloitte.com

View our website for additional information:
www.deloitte.com/us/audit/consumer-industry

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