Preparing for the new lease accounting standard

What transportation, hospitality, and services companies need to know

Preface

The new lease accounting standard is expected to have a significant impact on companies in the transportation, hospitality, and services industries. 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).

Another significant related change is that companies will need to scrutinize their service contracts for requirements that are essentially “embedded leases”—and then account for those requirements as leases, not services.

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. (In the past, many companies mischaracterized the lease components of some service contracts as services, because under the old standard the end result was essentially the same. As a result, companies may need to reconsider those mischaracterizations, making the so–called practical expedient less practical and expedient than it may initially seem.)

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

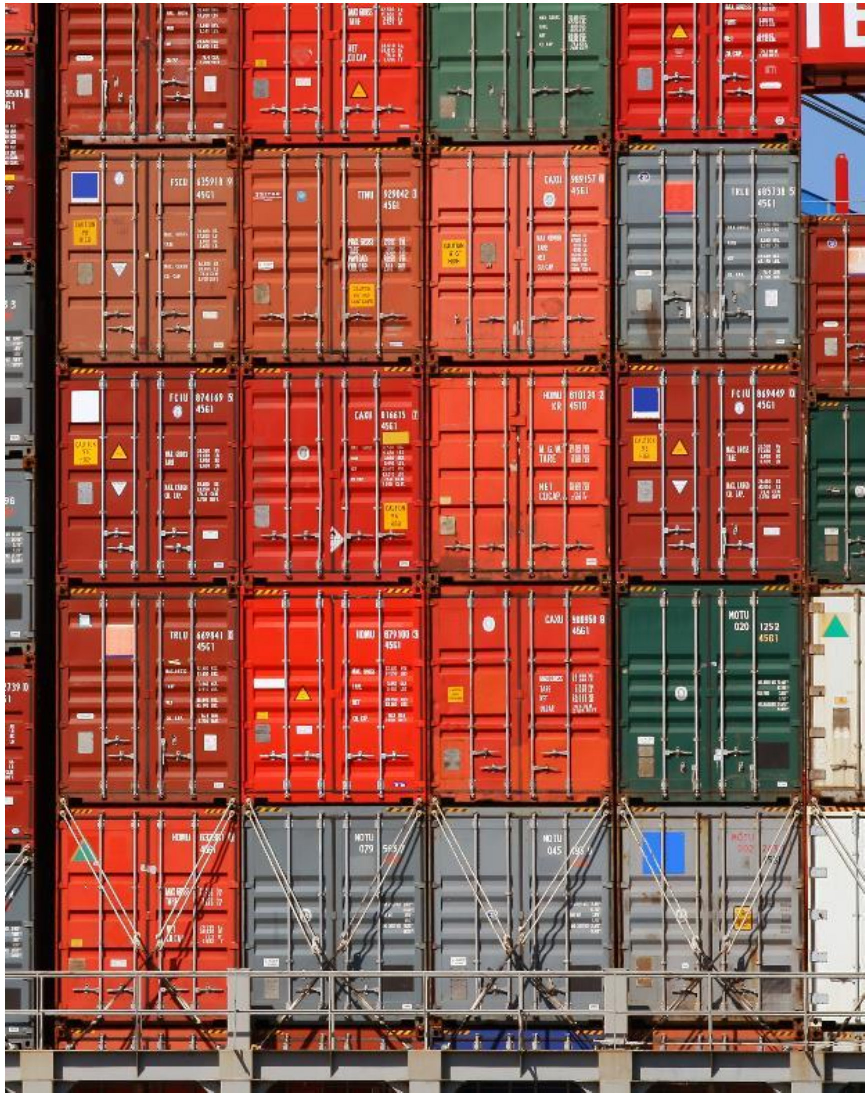
The new standard also significantly expands the required lease disclosures. Entities should consider these increased disclosure requirements early in their implementation efforts to ensure they are prepared.

Impact on transportation companies

The new standard is expected to have a major impact on transportation companies, which tend to be highly capital–intensive, have large fleets of vehicles, and rely heavily on leasing as a standard business practice. These companies will likely see a big increase in the size of their balance sheets, creating a significant ripple effect throughout the business and potentially onto the bottom line.

For example, shipping companies that "charter in" vessels might be greatly impacted because of their extensive use of fixed assets (i.e., vessels) under contracts that might be classified as leases under the new standard. Also, contracts for services that are critical to a lease—such as operating and maintaining a vessel throughout a voyage—might now appear on the balance sheet as leases, rather than being handled off the balance sheet as service expenses. Companies that "charter out" vessels will likely see a lesser impact.

Depending upon the nature of the lease, transportation companies that "lease in" assets may also see a change in where the income statement charges are classified. Leases that are considered to be finance leases would recognize costs as amortization of the right–of–use asset and interest, while leases that are considered to be operating leases would recognize costs as a lease expense. Companies that use EBITDA as a key metric will be impacted by this. Additionally, right–of–use assets will need to be considered for impairment.



Impact on services companies

In theory, the new leasing standard will have a relatively low impact on services companies because they tend to be less reliant on property, plant, and equipment leases. However, most services companies are not "pure" service businesses and thus may find many aspects of their operations significantly affected by the new standard.

For example, a service business with a large leased vehicle fleet and/or numerous leased facilities will face lease accounting issues and balance sheet impacts similar to those of a shipping or real estate company—just on a smaller scale.

Impact on hospitality companies

Companies in the hospitality industry will likely be greatly affected by the new standard. Large hospitality companies typically have thousands of operating leases—or service contracts with embedded lease components that need to be treated as operating leases—all of which now need to be aggregated and analyzed, then accounted for on the balance sheet.

In hotels, the challenge is amplified by the industry's unique and complex structure—with property owners, managers, and franchisers all playing different (but often overlapping) roles. In this structure, one entity might be accountable for the lease activities of another entity, so it is essential for everyone involved to understand what the others are doing with regard to leases, and to make sure their own entity's lease accounting is appropriate for the circumstances. The recognition, measurements and disclosures of hotel room revenue will need to be evaluated for material difference under ASC 842, as compared to those under ASC 606.

Many of the hospitality executives we have spoken with are surprised by the amount of work that will be required to comply with the new leasing standard. To date, much of their focus has been on the new revenue recognition standard, so these leasing issues are a bit of a blind side. Given that hospitality companies can play the role of lessee and lessor, the large data collection activity and the related accounting this creates require a software solution. Yet, software for managing leases using the new standard is still immature and under development, making technology selection difficult at the moment.

Other considerations for hospitality companies: Lessees are required to reassess lease terms after inception in certain circumstances. Companies need a mechanism to identify these events in advance in order to be in a position to recover the investment. Companies also need to be aware of and pay attention to leasebacks and build to suit arrangements so failed sale leasebacks can be reassessed for possible derecognition under the 842 model.

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

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