



Flashpoint

Changes to lease accounting standards

Exploring the impact beyond the balance sheet

Changes to accounting rules will require organizations to radically transform how they account for leases. The changes mean all publicly traded companies worldwide will have to report their leases as both assets and liabilities on their balance sheets.

The revised standards—the issuance of the global lease accounting standard, IAS 16, of the International Accounting Standards Board and the Financial Accounting Standards Board’s Accounting Standards Update (ASU) 842—will take effect on January 1, 2019, or for any fiscal year beginning in calendar year 2019.

Until now, only capital or “finance” leases have been required on balance sheets, as both a liability and a fixed asset—effectively treated as a means for acquiring an asset. That aspect of the standards does not change, but new requirements mean that operating leases—that is, leases that fall more into the traditional rental realm—will soon have to be reflected on balance sheets.

The new standards specifically require that operating leases of 12 months or more must be reflected on the balance sheet as both assets and liabilities—even if the lessee’s intent is to return the asset to the owner or landlord. The standards apply to real estate as well as tangible property—extending to all property, plant, and equipment (PP&E) items.

(Intangibles remain excluded, however.)

The revamped standards represent a huge change for all companies operating in the technology, media, and telecommunications (TMT) space and will significantly increase the amount of debt on balance sheets—by perhaps as much as \$2 trillion for all U.S. public companies.

Ultimately, the new approach to lease accounting should provide investors and other stakeholders with a more transparent and complete view of a company’s financial picture. But it will mean a lot of work for these industries. Companies across the world will have to upgrade their business processes and supporting technologies to comply with the standards.

For TMT companies, the expected work will be significant. The telecommunications industry, for example, will face questions on everything from towers and real estate to fiber networks, set-top boxes, and hardware. Media companies, meanwhile, will face similar challenges, with special questions arising over advertising services received and the assets used in advertising media content (for example, billboards and web properties)—specifically, whether an identified asset exists, how much of the asset’s economic benefit a media company receives, and whether the company controls the asset. And across

the technology space—and potentially all industries for that matter—the rise of cloud computing prompts big questions on services, ownership, and leases. For example, is a specific server explicitly designated for a client’s use? Or is the arrangement more implicit? Plenty of questions lie ahead for TMT organizations—and answers will require extensive insights, research, and people power.

What do TMT companies need to know? Here’s a look at some key issues surrounding the new lease accounting standards.

In this issue

- Data is king
- Impact on stakeholders will be significant
- Books can get complicated
- Timing is critical
- More work lies ahead

About *Flashpoints*

Every day brings new ideas and possibilities to the Technology, Media, and Telecommunications sectors. *Flashpoints* is your tool for gaining the context you need to make sense of these critical developments—as they emerge.

Key observations



Data is king

Gathering and managing data will be central to complying with the new lease accounting rule.



Impact on stakeholders will be significant

Looking at leases and potential leases in a new light will require critical thinkers and lease “detectives.”



Books can get complicated

Some organizations might consider keeping multiple sets of books to satisfy different needs and inquiries.



Timing is critical

The window for compliance is small, and the amount of work is great. It's imperative to get started right away.



More work lies ahead

The new rule will have a ripple effect on business processes, from contracts to internal controls to debt agreements with banks.

Data is king

To begin addressing the new standards, organizations will require tremendous amounts of data on what they own, what they lease, how they use it, how they pay, whom they pay—and more. The data will serve as a foundation for conducting a thorough and technical assessment of leases. For companies that are the results of years of mergers or operate in multiple countries, the necessary data might not all reside at the same place—complicating the data collection challenge.

In the data quest, organizations will have to look in file cabinets as well as electronic data repositories to inventory their leases and potential leases—since some agreements previously not viewed as leases might, in fact, be leases. Previously making a distinction between an operating lease and a service didn't matter, because the accounting treatment was similar. Now, the distinction becomes important, because leases will be recorded as “right-of-use assets” and liabilities on the balance sheet—while service

contracts will continue to be recorded “off balance sheet,” as they have been in the past. Companies also will have to review their complete lease inventory and the terms of leases to develop an understanding of their true exposure under applicable rules.

Having great data will not be enough. Companies will have to invest in new technology solutions that can manage data and help bring them into compliance with the new standards—tools that can capture relevant lease data, integrate it with business processes, and bring forward accurate and actionable lease-related information for balance sheet reporting.



Gathering and managing data will be central to complying with the new lease accounting rule.

Impact on stakeholders will be significant

Given the technical and data-intensive challenge of preparing for the rule change, many companies will realize that they will have to augment their workforces by increasing headcount or outsourcing to third parties, and increasing the level of interaction with other departments involved in lease activities.

The lease accounting change represents a shift beyond the spreadsheet thinking of the past. Stakeholders and employees in numerous departments—from real estate to sales to IT to the tax organization—will have to understand the requirements and the impact on their day-to-day jobs. Organizations will need employees to act as detectives to uncover and analyze potential leases—workers who can understand the consequences of classifying something as a lease.

Because so many stakeholders across the enterprise will be affected, companies also can expect to see a need for departments to interact and collaborate more to identify and manage leases and related activities. A real estate group and an accounting group, for example, might have to work more closely after the new lease accounting rules go fully into effect. Companies might consider new training programs to help stakeholders identify potential lease issues—in addition to understanding new revenue recognition rules. They will need to educate stakeholders to ensure that they understand consequences beyond their specific roles—to comprehend IT, tax, and other implications involved in lease decisions.



Looking at leases and potential leases in a new light will require critical thinkers and lease “detectives.”

Books can get complicated

Despite the seeming straightforwardness of the new rule, the potential for complications can arise when it comes to actually keeping the books. For example, as the accounting team assesses and books complex lease accounting arrangements, their actions will trigger decisions on allocation and which accounting rules apply.

One significant item to note: rules still vary between International Financial Reporting Standards (IFRS) and U.S Generally Accepted Accounting Principles (GAAP). Lease accounting rules under traditional tax accounting are not changing, and federal income tax lease classification rules are not changing. But there are potential downstream impacts on sales and use taxes. Some transactions at the state level, for example, could look like sales rather than leases, and taxing authorities may target them for tax.

Some organizations might find themselves realizing a need to keep as many as three sets of books, to help eliminate possibilities for confusion. They might keep one set of books for income tax purposes, one in alignment with GAAP or IFRS, and one devoted specifically to state and regulatory needs.



Some organizations might consider keeping multiple sets of books to satisfy different needs and inquiries.

Timing is everything

Companies that have not begun formulating a lease accounting strategy might already be late to the game. The deadline is real and looming. Public business entities with a calendar year-end must comply by January 1, 2019. (Entities that do not meet the definition of a public business entity have until January 1, 2020.) You need to start now, if you haven't started already. It could take between 12 to 18 months to complete a transition to the new standards. You will require time to develop a plan and execute it, conducting the necessary reviews and testing along the way. You will require time to coordinate parallel testing to make sure new lease-related procedures do not conflict with other business processes and systems. It's

important not to underestimate the amount of work and time the transition will take.

You will also need to ensure that, after the change, you apply the new model for the earliest year presented in the financial statements—not simply rehash comparatives as they were presented under the old rules.

One final point about timing: Organizations soon will have to comply with the new revenue recognition guidance. Some might want to coordinate their implementation activities for both initiatives, including the impact on IT systems.



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More work lies ahead

The lease accounting change will not be a one-and-done situation. Going forward, organizations will have to continue looking critically at what they classify—or do not classify—as leases. You will have to remain cautious about how you tailor contracts. Modifications to a contract could result in previously off-balance-sheet items needing to be moved onto the balance sheet, for example.

Looking intently at revenue contracts with multiple deliverables—and whether any represent a lease—will be critical as you move forward. Leases embedded within contracts might not be obvious or easy to track. To comply fully with the new standards, you likely will have to develop an ability to effectively separate, or bifurcate, services from leases within existing contracts.

Be aware that the IT systems and business processes that touch on a contract could require changes to ensure that items and

transactions are accounted for properly. You also will need to think about the ongoing processes and controls you will require to remain in compliance with the new rules. The change, therefore, will have ripple effects far beyond balance sheet accounting—both in upstream and downstream processes.

In the future, previously off-balance-sheet items will be on the balance sheet—whether you own them outright or not. Your ability to calculate net present value will be critical, as well as a new ability to look at the long-term implications that come with changes to your balance sheet. The new lease accounting standards also might have an impact on your debt agreements with banks, for example—since the debt on your balance sheet could increase. And that also could affect your plans to acquire other companies.



The new rule will have a ripple effect on business processes, from contracts to internal controls to debt agreements with banks.

Let's talk

Effectively adopting the new lease accounting rules will require organizations to develop a strategic path forward and transform their enterprises to support a new vision for lease accounting.

Organizations that fail to consider the importance of data, people, planning, and timing could find themselves drifting toward noncompliance. Determining how to proceed on the new lease accounting journey will demand discipline, insights, and in-depth guidance. Want to know how to get started on the journey? We should talk.

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