BOULAY

New Lease Accounting Rules will Require Substantially All Leases to be Capitalized on the Balance Sheet

February 2016

Prepared by: Anthony Seyffer, CPA, Supervisor

Overview

The Financial Accounting Standards Board has proposed new lease accounting standards that are expected to be finalized and issued in early 2016. The new rules, which will require companies to record substantially all leases on their balance sheets, including existing leases, will transform lease accounting and will have a significant impact on company's financial statements, supporting systems and controls and other items such as debt agreements.

The existing accounting standards for leases require lessees to classify leases as either capital leases or operating leases and account for these leases differently. Under the new rules, all leases with a maximum term longer than 12 months will be capitalized on the balance sheet whereby lessees will be required to recognize a right-to-use asset and lease liability based on the present value of the payments required by the lease. Lessees with a large portfolio of leases are likely to see a significant increase in balance sheet assets and liabilities. Similar to today's capital leases, the FASB will require leases classified as "Type A" leases to be presented as a financing in the income statement when (1) payments represent substantially all of the fair value of the asset, (2) the lease term is for a major portion of the asset's economic life, (3) purchase of the asset is considered a bargain, or (4) title transfer is automatic at the end of the lease. The fair value and economic life tests are expected to be similar to the 90% and 75% tests under existing U.S. GAAP guidance. All other leases would be classified as "Type B" leases whereby the income statement classification will be similar to today's operating leases with costs presented as lease expense and recognized on a straight-line basis over the lease term. This dual model for income statement classification is expected to limit the impact of the proposed changes on the income statement and statement of cash flows.

Public Companies

Public companies will be required to adopt the new leasing standard for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For calendar year-end public companies, this means an adoption date of January 1, 2019 and retrospective application to previously issued annual and interim financial statements for 2018 and 2017.

Nonpublic Companies

Nonpublic companies will be required to apply the new leasing standard for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. For nonpublic calendar year-end companies, this means an adoption date of January 1, 2020 and retrospective application to previously issued annual financial statements for 2019 and 2018.

Preparing for the New Rules

Below are four steps companies should take to prepare for the new rules:

1. Begin with a strategic evaluation of all current leases, starting with the largest leases, and assess how they will be accounted for under the new rules to determine the monetary value of the leases that will need to be added to the balance sheet.
2. Consider renegotiating leases now even if they are not up for renewal if there is a significant negative impact on the company's financial statements. Most lessors are willing to renegotiate a lease if you extend its term. During the renegotiation process, pay special attention to what amounts are outlined as rent payments versus service charges since service charges will continue to be expensed as incurred and will not be rolled onto the balance sheet.
3. Evaluate the impact and determine whether the company will be required to update any of its accounting software to support the lease accounting changes. Is the change something that the current package can easily and reasonably handle? In some cases, new systems, controls, and processes may be warranted, which will take additional time to obtain or develop, implement, and test.
4. Identify the right team of individuals to help transition to the new standards and start the strategic work now. Based on the effective date and the need for retrospective application to prior years, companies should focus on their ability to gather the required

information on existing leases and capture data on new leases, which will be critical to an effective transition.

By anticipating how new and existing leases will be classified and accounted for under the new standards, CFOs will be in a much better position to develop a strategy that minimizes any negative impact the lease accounting rules changes would otherwise have on financial statements.

To learn more about new lease accounting rules, contact a Boulay advisor at 952-893-9320 or learnmore@BoulayGroup.com.