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Lessees: A Stitch in Time Will Save Problems Down the Line

By Steven Kahn

On November 15, 2019, the Financial Accounting Standards Board (FASB) announced it had officially delayed implementing certain accounting standards for private companies, including the new lease accounting standard (ASC 842) for an additional year, from January 1, 2020 to January 1, 2021. But don't breathe a sigh of relief yet. You will need this extra time to understand the process involved and to collect all the necessary data in order to comply by the deadline.

Public companies had to comply with ASC 842 by January 1, 2019. Financial executives had underestimated the complexity and the amount of time, resources and cost involved. As a result, the deadline for private companies was delayed. This postponement was welcomed, especially as private companies grapple with adopting other new standards that went into effect this year.

This change has added billions of dollars to the balance sheets of many public companies, in both assets and liabilities. In the past, these lease commitments were off balance sheet and tucked away in the notes to the financial statements. The increase in liabilities can create problems with meeting loan covenants. Common leases are for real property, automobiles and equipment. Under ASC 842, the definition of a lease is much broader in scope and includes many contracts, including service contracts, and may contain what the standard refers to as embedded leases. These are extremely difficult to identify and need to be bifurcated and accounted for separately.

For example, a lessor and a lessee enter into a 10-year maintenance agreement for a crane to be used in the lessee's construction business. Included in the agreement, the lessor is to provide the lessee with the use of the crane for the lease term. Total payments for maintenance services and use of the crane over the term of the contract is $175,000. Stand-alone prices to lease and maintain the cranes for similar periods would be $140,000 and $50,000, respectively. The payments for the maintenance contract are considered a non-lease component and must be separated from its lease component. Therefore, $128,947 ($140,000/$190,000 x $175,000) would be allocated as fixed lease payments and $46,053 ($50,000/$190,000 x $175,000) would be allocated and accounted for separately, as they represent the non-lease component of the contract. A company may elect, by class of underlying asset, not to separate non-lease components from the lease components and account for the combined as a single lease component. Although that sounds like a reprieve, the downside is a higher liability on the balance sheet.

Public companies quickly realized that implementation required the dedication of many groups from within their organization. Input and time was needed from the accounting/finance personnel and various other departments such as real estate, legal, IT, HR and procurement. In addition, companies felt that their initial assessment of the efforts needed were underestimated in identifying the population of their leases, especially those with embedded features as mentioned above, as well as the complexity of the calculation and the amounts of inputs and lease data required to perform an accurate calculation of the assets and liabilities. For companies with few leases, excel spreadsheets may have been adequate; however, companies with hundreds of leases found them to be too labor intensive and required the use of consultants and/or software to manage ongoing compliance.

Private company executives would be prudent to learn from the difficulties that public companies encountered. The one-year reprieve should not be a reason to postpone, but rather looked upon as an opportunity to take advantage of the lessons learned and plan for a successful implementation of the standard in the most expeditious manner. The following is a list of suggestions to consider:

- Identify a lease accounting and management team.
- Provide proper training for internal personnel.
- Determine the lease population (including related party leases).
- Make sure to begin the abstraction process early to identify key terms needed to perform calculations.
- Put in place a mechanism to identify embedded lease arrangements in service contracts.
- Establish a method to determine incremental borrowing rates to be used.
- Make required policy elections and evaluation adoption of practical expedients.
- Determine if an outside consultant/software service provider is needed to perform. calculations or can be performed internally.
- Calculate the impact to the opening balance sheet.
- Understand the impact to financial statements, disclosures, taxes, existing business processes and internal controls to ensure compliance.

There is no time like the present to begin the process of putting in motion the above recommendations. Although the date of implementation has been postponed, DO NOT POSTPONE GETTING STARTED ON THIS PROJECT.

For more information or for assistance with implementation, please reach out to your Anchin Relationship Partner or a member of Anchin's Real Estate Group.

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