Requirements for lease accounting are evolving

Caty Beilsmith, CPA, CCIFP
Partner, Business Services, Mueller Prost

The requirements for lease accounting are evolving with the issuance of ASU 2016-02, Leases, which will directly affect all industry sectors, including the construction and real estate industries. Particularly, companies who have a large number of operating leases should pay close attention to the new standard.

The new standard is currently effective for non-public companies for fiscal years beginning after December 15, 2019 and interim periods with fiscal years beginning after December 15, 2020. However, the FASB Board voted on July 17th to draft an Accounting Standards Update (ASU) that would delay the effective date by one year. The standard can be implemented using two approaches:

1. Modified retrospective method in which the new rules are applied at the beginning of the earliest period presented in the financial statements.
2. Retrospective method in which a cumulative effect adjustment to equity is recorded, but prior comparative periods are not adjusted. We expect many companies will elect the option to not restate prior periods.

Prior to the new standard, leases were recorded in one of two ways:

1. Capital leases – recorded on the balance sheet as if the lease asset was financed.
2. Operating leases – lease payments recorded as expenses in the period incurred and no related asset or liability were recognized.

The new standard now requires lessees to recognize most leases on their balance sheet as a *right-to-use asset* with a corresponding *lease liabilit*y. This may also include related party leases whose current terms are on a month-to-month basis if there is clear indication that the actual term will be longer.

Although the purpose of the new standard is to bring added transparency and comparability to the balance sheet, these changes will potentially impact financial ratios that lenders or sureties may use when evaluating the company including EBITDA and debt to equity ratios.

As we head into the second half of 2019, it's important to remember that early preparation and planning is key for successful implementation of the new standard. Even if the delay is approved, we recommend using time to your advantage and taking the following steps now to assist with this process:

1. The company will need to review existing arrangements to determine if they meet the definition of a lease, make judgments and calculations required under the new standard, and implement the appropriate processes, controls and systems for ongoing monitoring of the leases.
2. Depending on the number of leases you have, you may want to explore a lease tracking software as an excel model of tracking may become difficult.
3. We also suggest talking with your lender and sureties to discuss the effects of the new standard and whether any modifications to loan agreements and related ratios will be necessary. Based on these discussions, other business implications including buy vs. lease decisions may want to be considered.

If you have any questions about the new lease standard or would like to learn more about how these changes will impact your company, please contact Caty Beilsmith, CPA, CCIFP at cbeilsmith@muellerprost.com or directly at 314-480-1394.