IS YOUR COMPANY PREPARED FOR THE NEW LEASE STANDARDS?

On February 25, 2016, the FASB issued an Accounting Standards Update intended to improve financial reporting on leasing transactions. The new standard will impact companies and other organizations that lease assets such as real estate, vehicles, airplane manufacturing equipment and office equipment.

The new standards require companies to recognize the rights and obligations created by certain leases as assets and liabilities on the balance sheet. By impacting the balance sheet, the new standards may also impact the ability to acquire capital, debt covenants and lease versus buy decisions.

The standard is effective for public companies for fiscal years beginning after December 15, 2018, and fiscal years beginning after December 15, 2019, for private companies. Companies are permitted to adopt the new standard prior to the effective date.

It’s critical to ensure your company is prepared for the new lease standards. Preparation may take considerable time and effort depending on the number and complexity of your lease arrangements and access to existing data.

Here are three initiatives you can begin now to ensure your company is ready:

**REVIEW & EDUCATE**
- Review existing contracts to identify lease arrangements under the new standards.
- Consider potential impacts on company operations.
- Determine if IT systems can capture appropriate information and perform required calculations.
- Educate accounting staff on the new requirements and impacts.

**EVALUATE THE FINANCIAL IMPACTS**
- Estimate first year impact on the balance sheet.
- Analyze contracts for possible accounting treatment revisions.
- Review debt covenants for potential compliance issues.
- Identify internal controls and update accounting policies and procedures.

**BEGIN TO IMPLEMENT**
- Plan IT system changes required to capture data and properly record leases to financial statements.
- Work with legal counsel to revise contracts, where necessary.
- Communicate with internal and external stakeholders.
- Update financial reporting, including required disclosures.
**STEP 1**

Determine whether or not a contract contains a lease.

The new standard redefines what constitutes a lease. With the new definition, evaluation of whether a contract is (or contains) a lease is very important.

1. **Is there an identified asset?**
   - **NO**
   - **YES**
     - **Does the customer have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use?**
       - **NO**
       - **YES**
         - **Does the customer or the supplier have the right to direct how and for what purpose the identified asset is used throughout the period of use?**
           - **NO**
           - **YES**
             - **Customer**
               - **YES**
                 - **Does the customer have the right to operate the asset throughout the period of use without the supplier having the right to change those operating instructions?**
                   - **NO**
                     - **Did the customer design the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use?**
                       - **NO**

   - **NO**

**CONTRACT DOES NOT CONTAIN A LEASE**
**STEP 2**

Record the lease based on the appropriate classification.
Lessees will recognize finance, operating, or short-term leases.

| 1. Payments represent substantially all of the fair value of the asset | **12 Months or Less** |
| 2. The lease term is for a major portion of the asset’s economic life |
| 3. Bargain purchase option |
| 4. Title transfer at the end of the lease, or |
| 5. Specialized nature of the asset leaves lessor with no alternative use at end of lease |

<table>
<thead>
<tr>
<th>LEASE TYPE</th>
<th>Finance lease</th>
<th>Operating lease</th>
<th>Short-term lease</th>
</tr>
</thead>
<tbody>
<tr>
<td>BALANCE SHEET</td>
<td>Right-of-use asset(^{**}) &amp; lease liability(^{*})</td>
<td>Right-of-use asset(^{**}) &amp; lease liability(^{*})</td>
<td>No impact</td>
</tr>
<tr>
<td>INCOME STATEMENT</td>
<td>Amortization expense, interest expense</td>
<td>Single lease expense on straight line basis</td>
<td>Single lease expense on straight line basis</td>
</tr>
<tr>
<td>CASH FLOW STATEMENT</td>
<td>Cash paid for principal and interest payments</td>
<td>Cash paid for lease payments</td>
<td>Cash paid for lease payments</td>
</tr>
</tbody>
</table>

\(^{*}\) Lease Liability = Present value of unpaid lease payments  
\(^{**}\) ROU Asset = Lease liability + Initial direct costs + Prepaid lease payments – Lease incentives received
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