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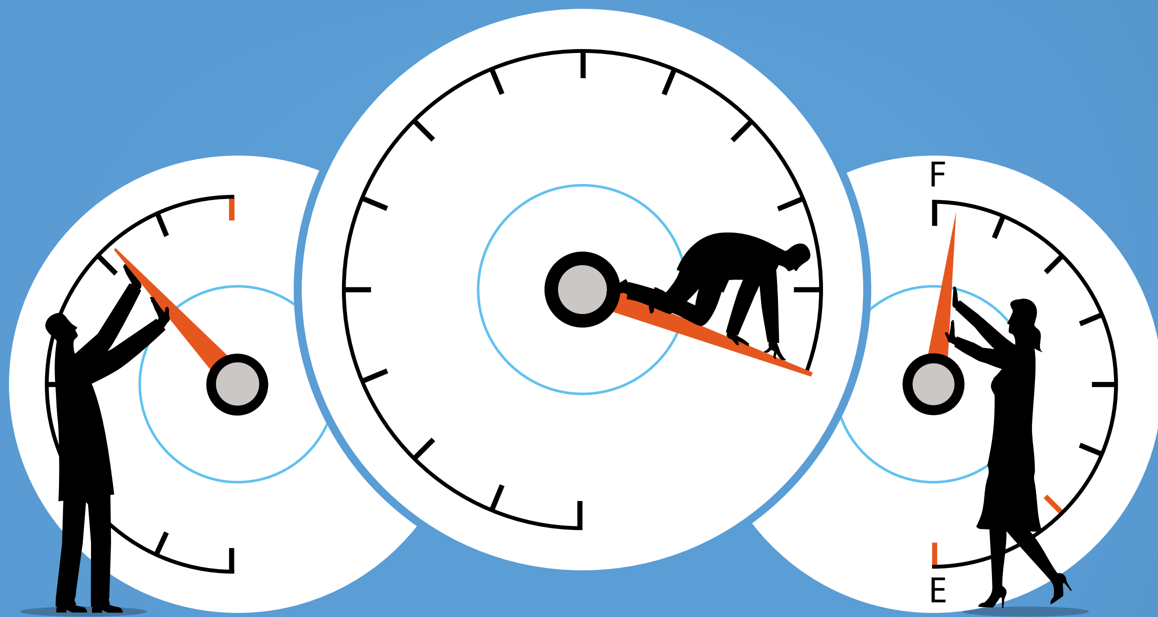

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Lease Update: Impact to Dealerships

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In February, 2016, the Financial Accounting Standards Board (FASB) issued an Accounting Standard Update (ASU 2016-02) that amends the accounting guidance on leases. The guidance defines new principles for the recognition, measurement, presentation, and disclosure of leases for both lessees and lessors. Under this new standard, a company is required to recognize most leases on its balance sheet, whether it was previously treated as a capital lease or an operating lease. A key difference with the new guidance is the requirement for lessees to recognize, on their balance sheet, lease contracts with lease terms greater than 12 months. Specifically, lessees are required to recognize at lease commencement, both:

- A right-of-use (ROU) asset: representing the lessee's right to use the underlying asset over the term of the lease.
- A lease liability: representing the lessee's contractual obligation to make lease payments over the term of the lease.

Leases will be classified as either a finance or operating lease, comparable to the current capital and operating lease classification. Overall, lessor accounting is unchanged from the new guidance, with the exception of some revisions made to ensure consistency with the revised lessee guidance.

The new standard will impact dealership financial statements but the impact is not expected to be as significant as other industries, such as telecommunications, airlines and banks. The range of the balance sheet impact is currently being evaluated by dealership groups. In its March 31, 2018, SEC Form 10-Q filing, AutoNation disclosed that it expects to recognize additional ROU assets and operating liabilities ranging from $375 million to $475 million. CarMax disclosed in its May 31, 2018, Form 10-Q filing that it expects to record a $400 million to $430 million increase in both assets and liabilities on its balance sheet as a result of the new lease standard. Beyond the financial statement effects, the new standard may affect multiple aspects of business operations, including certain key metrics and debt covenants. Some of the potential metrics that may be impacted by the updated guidance include the following:

- Leverage ratio – debt/equity
- Current ratio – current assets/current liabilities
- Debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) – debt/EBITDA
- Return on assets – net income/assets

Identifying a Lease

A company is required to evaluate whether a contract is or includes an embedded lease within the contract. A contract is defined as being, or containing, a lease if it conveys the right to control the use of the identified asset for a period of time in exchange for consideration. The concept of "control" over the use of the asset means the customer has both (i) the right to obtain substantially all of the economic benefits from the use of the asset, and (ii) the right to direct the use of the asset. This assessment will require judgment. One example for a dealership to consider is billboard advertising. Depending upon the language of the contract, the dealership's use of the billboard might constitute a lease and require the dealership to record a ROU and liability.

Short-Term Leases

As an exception to the general requirement that all leases be recognized on the balance sheet, the new lease standard allows companies to account for a lease, whose term is 12 months or less, off the balance sheet – similar to an operating lease under existing accounting guidance. However, if a company elects to apply this short-term lease exception, it must do so for all similar qualifying leases within the same asset class (e.g., all qualifying short-term laptop leases).

Classification

Leases are required to be classified by lessees as either operating leases or finance leases. A lease contract is a finance lease for a lessee, if any of the following are met at lease commencement:

1. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
2. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
3. The lease term is for the major part of the remaining economic life of the underlying asset. (However, if the commencement date falls at, or near, the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.)
4. The present value of the sum of the lease payments and any residual value guaranteed by the lessee equals, or exceeds, substantially all of the fair value of the underlying asset.
5. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

The new classification criteria are substantially the same as the old lease classification criteria with the addition of the relation to the specialized nature of the asset. There are no more "bright-line" tests specifically included in the new guidance (75 percent of useful life and 90 percent of present value of lease payments), however the standard allows companies to use these previous "bright-lines" as a reasonable approach for assessing the criteria listed above.

Initial Measurement

The initial lease liability is recorded at an amount equal to the present value of the remaining lease payments due over the lease term, discounted at the implicit lease rate. If a lessee cannot readily determine the rate implicit in the lease, it should use its incremental borrowing rate to discount the lease. Additionally, private companies have the option to use the risk-free rate; however, the risk-free rate is typically lower than the incremental borrowing rate, which would result in a larger liability.

The ROU asset is initially recorded at an amount equal to:

- The initial lease liability, plus
- Any lease payment made at or before lease commencement, plus
- Any initial direct costs incurred by the lessee, less
- Any lease incentives received from the lessor

Effective Date

The new guidance is effective for public business entities for fiscal years beginning after Dec. 15, 2018 (e.g., Dec. 31, 2019 calendar year-ends), and interim periods therein. For private companies, the standard update will be effective for fiscal years beginning after Dec. 15, 2020 (e.g., Dec. 31, 2021 calendar year-ends), and interim periods thereafter. Early adoption will be permitted for all entities. The standard requires a modified retrospective application, which will require companies to apply the new guidance as of the beginning of the earliest comparative period presented in the period in which the standard is adopted.

Example

ABC Dealership enters into a ten year real estate lease with lease payments of $50,000 per year; incurs initial direct costs of $10,000; has an incremental borrowing rate of 5.50 percent (unable to determine the implicit rate in the lease); and makes the first lease payment and the initial direct costs totaling $60,000.

Journal entry at inception:

	DEBIT	CREDIT	NOTES
ROU asset	$407,610		Lease liability + first lease payment of $50,000 + initial direct cost of $10,000
Lease liability		$347,610	9 remaining lease payments discounted at 5.5%
Cash		$50,000	Lease payment
Cash		$10,000	Initial direct costs

If the lease was determined to be a ***finance lease***, the following adjustment would be recorded for the first year:

	DEBIT	CREDIT	NOTES
Amortization expense	$40,761		Amortize the ROU on straight-line basis over 10 years
Interest expense	$19,119		Initial lease liability x discount rate of 5.5%
ROU asset		$40,761	
Lease liability		$19,119	

If the lease was determined to be an ***operating lease***, the following adjustment would be recorded for the first year of the lease:

	DEBIT	CREDIT	NOTES
Lease expense	$51,000		Equal to 1/10th of total cash payments to be made during lease term so $50,000 plus 1/10th of initial direct cost, or $1,000
Lease liability		$19,119	Initial lease liability x discount rate of 5.5%
ROU asset		$31,881	Residual balance from rest of the entry

One of the primary differences in the example included above is the amortization of the ROU. As a finance lease, the ROU is amortized on a straight line basis over the term of the lease which resulted in an amortization expense of $40,761, however, as an operating lease the ROU is measured at the end of the year based on the value of the lease liability plus the remaining initial direct costs which resulted in amortization expense of $31,881.

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