UHY LLP
Certified Public Accountants

MANUFACTURING INSIDER

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THE IMPACT OF NEW LEASE ACCOUNTING STANDARD

WHAT HAS HAPPENED?

To enhance transparency and comparability of financial statements and minimize off-balance sheet items, the Financial Accounting Standards Board (FASB) issued its long-awaited new accounting requirements for leases ("ASC 842") in early 2016. There are elements of the new accounting requirements for leases that could impact almost all entities to some extent, although lessees will likely see the most significant changes.

ASC 842 is effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. All others must follow a year later—for fiscal years beginning after December 15, 2019. Early adoption of the requirements is permitted for all organizations. The new standard provides a new definition of a lease based on whether one party obtains the right to control the use of an identified asset for a period of time in exchange for consideration. It also classifies all leases as either finance or operating and there is no scope exception for leases of low value assets such as personal computers or copiers. However, lessees can elect an accounting policy to not recognize the lease terms that are for 12 months or less duration and where there is no option to purchase the underlying asset.

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The next level of service

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Accounting used by lessors will remain largely unchanged from current generally accepted accounting principles ("ASC 840"). The new standard does make some targeted improvements, updates revenue recognition requirements (for example, assessment of collectability in order to qualify for sales-type lease or direct financing lease), and adds disclosures.

The new standard will cause major changes in lessees' balance sheets (or statements of financial position) and disclosure requirements. ASC 840 does not require assets and liabilities to be recognized for most lessees. Under ASC 842, all lessees must report in their balance sheets a "right-of-use" asset, representing the right to use the underlying asset during the lease term, and a liability to make lease payments over the lease term. Recognition, measurement, and presentation of expenses and cash flows in the lessees' other financial statements won't change significantly.

A SIMPLE OPERATING LEASE EXAMPLE FOR LESSEE

A lessee enters into a three-year lease contract for an office located on the 38th floor and agrees to make the following annual payments at the end of each year: $10,000 in year 1, $15,000 in year 2, and $20,000 in year 3. The initial measurement of the right-of-use asset and liability to make lease payments is $38,000 at a discount rate of 8%.

First, the contract contains an identified asset, the office space located on the 38th floor, and the lessee has the right to use the office space for 3 years. The lessee determined that there is no other nonlease component in the contract and determined it is an operating lease since none of the following criteria is met for qualifying as a finance lease:

- Lease transfers ownership at end of lease term;
- Lease grants lessee an option to purchase the asset that lessee is reasonably certain to exercise;
- Lease term is for a major part of remaining economic life of asset;
- PV (lease payments + residual value guarantee) > = substantially all of the FV (fair value) of the asset (Payments related to optional periods or early termination options should be included only if lessee is reasonably certain to exercise the option.);
- Asset is of such a specialized nature that it is expected to have no alternative future use to the lessor at end of lease term.

At the commencement date (assuming January 1, 2019), the lessee will recognize right of use asset and lease liability in the amount of $38,000. At the end of first year, record interest expense ($3,038) and amortization ($15,000-$3,038=$11,962) together as a single cost (rent expense: $15,000) on a straight-line basis.

TRANSITION

There are two transition approaches available; (1) Modified retrospective approach to each prior reporting period presented that is intended to maximize comparability and be less complex than a full retrospective approach; and (2) Transition relief option with the cumulative effect recognized at beginning of the period of adoption. For example, a public business entity for which the standard becomes effective on January 1, 2019 would under the modified retrospective approach, recognize an adjustment for the effects of the transition as of January 1, 2017 (i.e., the date of initial application). Under transition relief option, the company would recognize the effects of applying ASC 842 as a cumulative-effect adjustment to retained earnings as of January 1, 2019 and apply ASC 840 in the comparative periods.

BUSINESS IMPLICATIONS

The business implications are broad and it is important to communicate the changes and impact to all stakeholders such as accounting, treasury, information technology, internal control and creditors. The major changes are the treatment of operating leases for lessees and more judgement required for the assessment of lease agreements. As a result, appropriately identifying a lease, especially service contracts that may contain embedded leases, becomes important because it could cause a financial misstatement. The company should begin to consider creating a transition timeline and action plan which should include:

- Form an implementation team to evaluate the new accounting requirements for leases;
- Inventory lease agreements, including key terms;
- Evaluate how the leases will be accounted for over the lease term and the adoption method to be used and its impact for financial reporting purposes;
- Identify improvements needed in financial reporting and internal control processes to capture, account for, and evaluate lease agreements;
- Assess the impact on financial covenants and creditworthiness with its lenders, investors and rating agencies.

For more information on how this standard will affect your business, contact your UHY LLP partner.

Venus Wu, Principal
(New York, NY)

"The major changes are the treatment of operating leases for lessees and more judgement required for the assessment of lease agreements."

DEFINING YOUR WHY TO ATTRACT AND RETAIN TALENT

What comes to mind when you think of companies like Apple, Patagonia, and Ferrari? Success. Vision. Passion. Purpose. Most likely, it's a combination of all these answers. These companies have a reputation for not only being highly successful, they are also known for their strategic forward-looking vision, passion for what they do, and clear purpose. These companies transcend manufacturing; they have nurtured cultures that focus both on business and the additional impact they can have on the world. How do they accomplish this, and what does this have to do with manufacturing?

"I BELIEVE FACTORIES ARE MADE OF MACHINES, WALLS AND PEOPLE. FERRARI IS MADE MOST OF ALL BY PEOPLE."
— Enzo Ferrari

MANUFACTURING OUTLOOK

The current outlook for manufacturing companies is extremely bright. Manufacturing productivity is up 1.4 percent year-over-year in the third quarter of 2018[1]. There is a 92.5 percent positive outlook for medium-sized companies, employment is expected to increase 2.5 percent, and sales growth is expected to increase 5 percent[2]. However, even with this positive outlook, there are still multiple challenges facing the industry. According to a recent survey conducted by the National Manufacturing Association, ***73.2 percent of companies state that attracting and reaching a quality workforce is their primary business challenge[3].*** What is the impact of this challenge? Due to the inability to attract and retain workers:

- 28.4 percent of manufacturers have turned down new business
- 33.2 percent held off plans to expand or create new jobs
- 44.4 percent cite the inability to attract and retain a talented workforce as the biggest threat facing their business[4]

With all this in mind, what is the key to attracting and retaining the best talent? The answer isn't what you might think. In today's competitive labor market, employees want more than just a good paycheck. They want to know that what they do on a daily basis matters; to havea purpose and a reason for WHY their job matters. This is not something that happens overnight, and it requires a company to reexamine and revise 'what makes them tick'; their WHY.

There are three initial steps to put a company on the path to attract and retain the best talent:

1. Define your WHY.
2. Drive your WHY.
3. Leverage your WHY.

DEFINE YOUR WHY

The first step to attracting and retaining talent is to define your WHY using the Golden Circle developed by Simon Sinek. This approach explains that "people do not buy what you do; they buy why you do it" (see Figure 1). Defining and articulating WHY you exist and the purpose of your organization provides a clear motivation for your company that creates an emotional link between the company, the employees and the customers. It is the very groundwork for sparking employee engagement, which is essential for attracting and retaining the best employees.

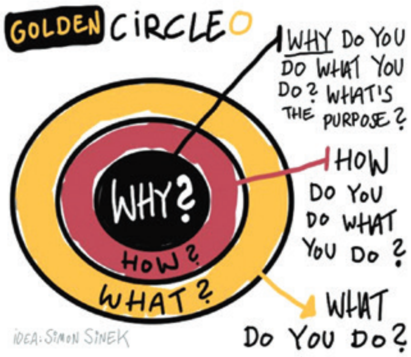

Figure 1: The Golden Circle by Simon Sinek

The WHY is your reason for being in business. It's your passion and purpose; the fire inside that drives you and your team every day. The WHY is the foundation for your culture, which gives your people an emotional connection to your company, your team, your products/services, and your customers. Without this emotional connection, you are likely to have issues attracting and retaining talent. Both your employees and customers need to understand why you do what you do.

When you think of Ferrari, you don't just see a car. You see unimpeded passion for driving, for beauty, for connection of man to machine…and, oh, they also produce cars. The same concept applies to Apple. Apple has a passion for simplifying technology; to enable seamless connections between people and technology that helps connect people while simplifying and improving their lives. Oh, and they make phones and watches, too. The point is, these companies can use their passion and purpose to drive their business. However, regardless of the products and or services they provide, they always stay focused on their WHY. Once you have your WHY, how do you ensure it is driven throughout your entire organization?

DRIVE YOUR WHY

You have heard the saying, "out of sight; out of mind". This is especially true for your WHY. To ensure this does not happen in your organization, you need to drive your WHY by incorporating it into your vision, mission, strategy, and core values. Most companies either do not have these areas defined or it's so far removed from daily operations that no one can tell you what it is (not even leadership). Each component needs to be well stated, communicated and understood by employees at all levels of the organization. The following is how all of these elements fit together as the foundation for your culture:

- The WHY is your vision for your entire organization.
- Your mission defines and clearly interprets your vision so it can be clearly and succinctly communicated to employees at all levels.
- Your strategy is how you approach achieving your mission.
- Your core values state the beliefs and behaviors needed to support your mission, your vision, and ultimately, your WHY.

It is essential to incorporate these into your daily operations to maintain your culture and the emotional connection for your people. You can use visual boards, posters, signs, statement cards, screensavers, etc. to make sure your WHY stays at the forefront for your employees. Developing these elements of your organization are crucial for clearly communicating who you are and retaining and attracting key talent.

LEVERAGE YOUR WHY

If you want to attract and retain the best employees, you need to also leverage your WHY. Sixty eight percent of people leave their organization because they are lacking an emotional connection[5]. Why is that? According to Maslow's hierarchy of needs, people have an inherent need to emotionally connect in order to live, work and deliver at their highest potential.

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[1]Source: United States Department of Labor – Bureau of Labor Statistics: https://www.bls.gov/opub/ted/2018/productivity-up-1-point-3-percent-third-quarter-of-2017-to-third-quarter-of-2018.htm
[2]Source: National Manufacturing Association - October 2018
[3]Source: National Manufacturing Association - October 2018
[4]Source: National Manufacturing Association - October 2018

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If you meet this basic need by leveraging your WHY and fostering the emotional connection, your people will wake up in the morning excited to pursue their goals and be a part of your team. They will be passionate about what you do and why you do it, and this culture of passion will resonate internally and externally. This provides a solid foundation to retain your current team, attract new talent, and have a reputation in the marketplace that also attracts more customers. You will have people who are passionate about what they do, and that passion will not only resonate within your company, it will also resonate with your customers and industry.

USING YOUR WHY

By defining, driving and leveraging your WHY, you enhance and sustain employee engagement. This allows you to mitigate the challenge of attracting and retaining talent in manufacturing. By creating a culture with the necessary emotional connection, your people will know their purpose and be passionate about both their work and their company. This level of employee satisfaction can overcome the temptations for employees to move to another company. You will have people who are passionate about what they do, engaged in their jobs, and enthusiastic to serve your customers and solidify your reputation as a company people want to work for. With this foundation in place, you enable broader thinking, a company that is more adaptable to the ever-changing business environment, passion that is evident from the top down and the bottom up, and efficiency. Find your WHY, and you will retain and attract top talent.

Stephen Lathrop, Principal
(Atlanta, GA)

> "The WHY is the foundation for your culture, which gives your people an emotional connection to your company, your team, your products/services, and your customers."

[5]Source: U.S. Department of Labor

CURRENT STATE OF THE MANUFACTURING INDUSTRY

According to a new Standard & Poor's report, there are two key indicators that will tell you what kind of shape the manufacturing industry is in. The first is the Institute for Supply Management's Purchasing Manager's Index and the second is the Federal Reserve's Capacity Utilization Index for motor vehicles and parts. A reading above 50 percent for the ISM index indicates that manufacturing is expanding in the US, and below 50 means that it is contracting. History shows that each time since 1983 that the index fell below 43 percent "speculative grade" automotive companies began to panic. Similarly any time the Fed's utilization rate dropped below 72 percent during that period, it caused stress to automotive companies. Let's take a look at where we stand as of December 2018:

ISM Purchasing Manager's Index: 54.1%

Fed Capacity Utilization Rate: 75.7%

MANUFACTURING INDUSTRY INSIGHT

UHY LLP recognizes that manufacturing companies require their auditors, tax specialists and business advisors to add value to financial reporting activities. That is why we combine the strength of business and financial expertise with a hands-on, "shop floor" approach to solving complex business decisions in these key segments:

- Aerospace & Defense
- Distribution
- Automotive Suppliers
- Industrial Manufacturing
- Consumer Products

Our professionals are leaders in the industry and take the steps necessary to ensure our client's future success by identifying and addressing new trends, accounting requirements and regulations.

OUR LOCATIONS

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MI Detroit 313 964 1040
MI Farmington Hills 248 355 1040
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