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Here We Go Again – Transitioning to the New Leases Standard

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Just as companies complying with United States generally accepted accounting principles (GAAP) are focused on transitioning to the Financial Accounting Standards Board's (FASB) revenue recognition standard,[1] the Board released, on February 25, 2016, its new standard on accounting for leases.[2] This standard will revolutionize lease accounting for lessees, affecting all companies and organizations – whether public, private or not-for-profit – that lease assets such as real estate, airplanes, ships, and construction, office or manufacturing equipment. And it will do so only one year after the revenue recognition rules change (two years for the small universe of companies which may be considering adopting the new revenue recognition standard in 2017).

The new standard will require lessees to recognize a lease liability and a right-of-use asset for all leases (except for short-term leases, i.e., duration of less than one year) as of the date on which the lessor makes the underlying asset available to the lessee (the commencement date):

- "Lease liability" is the lessee's obligation to make lease payments arising from a lease, measured on a discounted basis.
- A "right-of-use asset" is an asset that represents the lessee's right to use, or control the use of, a specified asset during the lease term.

With regard to income statement amortization for lessees, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Operating leases will result in straight-line expense recognition, while finance leases will result in a front-loaded expense pattern. Classification will be based on "consumption" of the asset, meaning that leases of property (i.e., real estate), which is typically not consumed during the lease period, will follow straight line amortization and leases of non-property (e.g., office equipment), which is

[1] Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606), issued on May 28, 2014.

[2] Accounting Standards Update No. 2016-02, Leases (Topic 842)), issued February 25, 2016.

typically consumed during the lease period, will follow an expense pattern similar to current capital leases.

In effect, because the new guidance requires lessees to recognize lease assets and lease liabilities, off-balance sheet financing – at least through the use of lease transactions – is taken off the table. Thus, accounting for sale and leaseback transactions has been simplified considerably.

For lessors, accounting for leases is substantially the same as in the past. The only changes result from some very specific adjustments to align the lessor accounting model with both the lessee accounting model and the revenue recognition standard to get the principles underlying the accounting in synch.

For public companies, the new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (thus, calendar year reporting companies must adopt the standard in 2019). For private companies, the new standard is effective for fiscal years beginning after December 15, 2019 (thus, calendar year reporting companies must adopt the standard in 2020). Early adoption is permitted for all companies, public or private. For leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, lessees and lessors must apply a modified retrospective transition approach.

The new standard reflects the input the FASB received during its extensive outreach with preparers, auditors and other practitioners (more than 200 meetings with preparers and users of financial statements; 15 public roundtables, with more than 180 representatives and organizations; 15 preparer workshops attended by representatives from more than 90 organizations; and 14 meetings with preparers). The FASB and IASB also met with more than 500 users of financial statements covering a broad range of industries whose feedback was instrumental in helping the FASB develop what the Board refers to as a "cost-effective, operational standard."[3]

As with the revenue recognition standard, the new lease accounting standard is the result of a collaborative effort by the FASB and the International Accounting Standards Board (IASB) to agree on a global standard based on common principles that can be applied across

[3] "FASB Releases Lease Accounting Standard," Michael Cohn, *Accounting Today*, February 25, 2016.

industries and regions.[4] While the FASB and IASB are aligned on most key decisions, some important U.S. GAAP/IFRS differences remain.

Why Change? – Objectives and Benefits

Under current accounting for leases, companies apply arbitrary rules to determine the nature of the lease – operating or capital – which, in turn, drives the appropriate accounting. The Board reports that many believe the current operating lease model fails to meet the needs of users of financial statements. The FASB's investor outreach program found that credit rating agencies, along with many industry-focused analysts and sophisticated investors, were already estimating lease obligations and adding them, in their analyses, to entities' balance sheets.[5]

The reason for these adjustments is that many firm valuation models make various adjustments to operating income to derive an estimated free cash flow. As such adjustments typically include adding back debt interest expense, it is necessary to adjust operating income, capital, profitability and cash flow measures for the effect of accounting for operating leases as an operating cost. In effect, many analysts and investors view operating lease expenses as financing costs. In addition to valuation model inputs, this adjustment can also affect some multiples such as enterprise value-to-EBITDA[6] ratios that are widely used in valuations to calculate a theoretical takeover value, which is similar to how an investment banker might value a company. Still another example is comparing two companies leasing the same types of assets, with one structuring its leases as operating leases and the other as capital leases. Thus, users are making adjustments using the transparency provided by the footnote disclosure of future minimum lease payments, because GAAP balance sheets and earnings don't give them what they need.

According to FASB vice chair James Kroeker, lease accounting was "one of the last remaining holes in off-balance sheet accounting that needed to be filled."[7] Since historically many leases have been structured to obtain favorable lease accounting, the new standard likely provides an opportunity for companies to focus more on enhancing the economics of the transaction as opposed to achieving an accounting objective.

[4] On January 12, 2016, the IASB issued IFRS 16, which is effective for reporting periods beginning on or after January 1, 2017, with earlier application permitted.

[5] "New FASB Lease Standard Could Inflate Balance Sheets," David M. Katz, *CFO*, February 25, 2016.

[6] EBITDA is earnings before interest, taxes, depreciation and amortization.

[7] Katz, *CFO*, "New FASB Lease Standard Could Inflate Balance Sheets."

Over 10 years ago, the U.S. Securities and Exchange Commission (SEC) issued a report on off-balance sheet activities that recommended changes to the existing lease accounting requirements to ensure greater transparency in financial reporting. A number of other studies have made similar recommendations. Interestingly, the SEC report disclosed that, based on SEC registrant filings in 2005, off-balance sheet operating lease commitments totaled an estimated $1.25 trillion. According to the FASB, more recently, its staff found in excess of a trillion dollars of undiscounted lease obligations that are reported in the footnotes based on 2014 public company filings presented in XBRL format. It's likely that the sheer size of these numbers ultimately compelled the Board to act.

In summary, the new guidance ends what the SEC and other stakeholders have identified as one of the largest forms of off-balance sheet accounting, while requiring certain disclosures related to leasing transactions. Therefore, while it was a very active past practice, going forward, it will be difficult for organizations to structure leasing transactions to achieve a particular outcome on the balance sheet and in earnings.

What's New?

The new standard amounts to a significant change in accounting for leases by lessees, as it requires them to recognize on the balance sheet the assets and liabilities for the rights and obligations created by all leases with lease terms of more than 12 months, regardless of how a lease is classified. As a result, balance sheets will grow for lessees that customarily enter into operating leases. It is important to note that the recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee will continue to be dependent on the classification of the lease as a finance or operating lease – generally consistent with current GAAP; however, both types of leases must be recognized on the balance sheet.

The new standard also will require disclosures to help investors and other financial statement users better understand the amount, timing and uncertainty of cash flows arising from leases. These disclosures include qualitative and quantitative requirements, providing additional information about the amounts recorded in the financial statements.

Accounting by lessors remains largely unchanged from current GAAP. The new standard requires some targeted improvements that are intended to align, where necessary, lessor accounting with the lessee accounting model and the updated revenue recognition guidance.

The new standard:

- Clarifies the definition of a lease to align the concept of control more closely with the principle used in revenue recognition and consolidation, addressing various practice issues within current GAAP.
- Continues to require the application of professional judgment, particularly when identifying a particular arrangement as a lease, determining the lease term, estimating lease payments, and calculating the discount rate.
- Consistent with current GAAP, provides that the lease term includes the non-cancellable term, as provided in the lease instrument, plus renewal periods that are reasonably certain of exercise by the lessee or are within the control of the lessor.
- Generally excludes variable rent payments; however, payments based on an index or rate are included based on the index or rate as of lease inception. As the index or rate changes over time and as changes occur in other variable payments, the effect of lease payments is treated in a manner similar to today's accounting for contingent rent payments.
- Provides that, when calculating present value, lessors will be required to include deferred initial direct costs in their calculation of the rate implicit in the lease, whereas lessees must include lease incentives in the cash flows used to determine the lease liability. Otherwise, the discount rate is determined in a manner similar to current practice.
- Requires lessees to remeasure the lease payments in certain circumstances when events occur that evidence the need for an adjustment. For example, when the lessee elects to exercise or not exercise an option contrary to the initial expectations at lease inception, reassessment of the lease term is appropriate. Likewise, when a contingency associated with a variable lease payment is subsequently resolved such that the variable lease payment now meets the definition of a lease payment, lease payments should be remeasured. Another example is when there is a change in the amounts that are probable of being paid by the lessee under a residual value guarantee. When the lessee remeasures the lease payments, variable lease payments based on a rate or index will need to be remeasured. This is a change from current GAAP, which does not require a reassessment of lease accounting unless there is a contract modification.
- Requires remeasurement of the lease liability when there is a remeasurement of the lease payments. When remeasuring the lease liability, the lessee is required to use an

updated discount rate, except in specified circumstances. Remeasurement of the lease liability results in an adjustment to the right-of-use asset on the balance sheet until it is reduced to zero, after which any remaining adjustment is recorded in the income statement.

- Does not permit lessors to reassess the determination of the lease term, variable rent or discount rate.

Lessees (for capital and operating leases) and lessors (for sales-type, direct financing and operating leases) are required to apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach.

Implications to Consider

While the new standard represents a big change, the good news is that many companies will probably be able to comply with it using their existing processes and systems, provided their current operating lease inventory is appropriately housed and cataloged. This revelation will strike a chord of relief for those companies that are finding that the implementation of the new revenue recognition standard imposes a significant transition challenge, requiring them to consider changes to elements of infrastructure from policies and processes all the way to systems and data. Because the new leasing standard retains the conceptual dividing line between capital and operating leases, it leaves unchanged the accounting for operating leases in the income statement and the statement of cash flows. That means that many companies with operating leases should be able to implement the new standard without wholesale changes to their existing processes, systems and reports.

The above said, lessees should nonetheless ensure that their policies, personnel, processes and reporting systems will be effective in generating the data and information needed to account for their leases in accordance with the new standard. For example:

- **Ensure the enterprisewide lease inventory is reliable**: Lessees should determine that all leases deployed across the organization are identified on a timely basis and aggregated to create a complete and accurate lease inventory. In addition, there should be an effective process for keeping the inventory up to date as leases are initiated, renewed, modified, remeasured and/or canceled. This process alone could require a substantial effort if the current process is disjointed and ad hoc.

- **Evaluate the supporting systems and data**: If lease data is managed through manual spreadsheets and multiple databases at multiple locations across the organization, companies should consider selecting and implementing a suitable technology solution to simplify the lease data gathering process, store and update the required data, generate the required journal entries, and support the required disclosures. One reason why this is an important step is the dynamic nature of managing a significant number of complex leases.
- **Look for embedded leases**: If the organization enters into an arrangement that explicitly identifies, and grants to the entity the right to use, property, plant or equipment, that arrangement constitutes a lease. Such arrangements may be embedded in service arrangements or included in a bundle of goods or services. If so, they, too, must be included in the enterprisewide lease inventory. For decentralized companies, it may take some time to analyze all agreements to ascertain whether embedded leases exist that require inclusion in the lease inventory.
- **Review the terms of existing financing obligations**: Lessees should review current debt agreements now to ensure the initial recording of new lease liabilities upon standard adoption would not be considered "new debt," thus triggering unwanted debt covenant violations in areas such as debt/equity and debt coverage ratios, to name a few.
- **Be mindful of expected changes in the business**: The organization should assess whether changes are expected to take place in the business that will affect the nature of the lease instruments deployed to obtain access to needed assets to run the business as well as alter the volume and complexity of leasing transactions. Such changes could require modifications in the underlying processes and systems.
- **Understand the new disclosures**: Company executives will want to understand the financial reporting and expanded disclosures under the new standard and how they may require modification to existing systems and processes. The disclosures required of lessees and lessors include, among other things, the nature of the issuer's leasing transactions, the rights and obligations created by the lease prior to commencement, management's significant assumptions and estimates, and a maturities summary.

The point is this: While the transition to the leasing standard may not place the same demands on management as the revenue recognition standard, it may take more than enough time to warrant management's careful consideration on a timely basis, especially as it comes right on the heels of the revenue recognition standard, the adoption of which will likely tap or consume resources in advance.

Transition to the new standard will have impacts beyond financial reporting that should be considered when developing a transition strategy. As a result of changes to the balance sheet, the transition may impact loan financial covenant compliance, key financial performance metrics, the budgeting and forecasting process, apportionment of income for state taxes, lease versus buy decision-making processes, and internal controls and SOX compliance.

As the standard really doesn't change the underlying economics of a company's financial position and cash flows, executives of lessee companies will have some explaining to do about their larger balance sheets. That shouldn't prove difficult. In essence, these companies will be bringing onto their balance sheets the future unpaid lease obligations in an operating lease by recording an equal right-to-use asset and an obligation to pay for those leases. This creates a more level playing field for investors by adding neutrality and comparability among entities regardless of whether they use leases to finance capital.

While CFOs will likely own the responsibility to assess the requirements of the new standard, its implications and the appropriate transition plan will necessitate a cross-functional effort. We believe that the following components will prove to be critical success factors in efforts to adopt the required changes:

- **Stakeholder awareness and education**: Educate the senior management team, key stakeholders across the organization, the board of directors and the street on the impact of the new standard. Establish training materials and provide training to prepare the organization's personnel for the standard's impact.
- **Project management**: For needed changes in processes and systems, manage the implementation process and provide for appropriate change management protocols. If the overall effort is significant, a project-driven discipline and approach is recommended (perhaps by a project management office [PMO] type structure for large, complex organizations).
- **Gap analysis**: Perform a high-level analysis of existing processes and data to ascertain whether all required information is available and whether any changes are required.
- **Resourcing**: Identify and assess resource needs to ensure lease inventory is complete and accurate, processes are improved, and systems are upgraded.

- **Communication strategy**: Develop a strategy for communicating with investors about the business and the nature of the company's leasing arrangements. Prepare to explain that the business fundamentals are unchanged and the change in accounting for leases does not alter those fundamentals. Will increasing both sides of the balance sheet without any change in equity affect investor's perception of the company and its capital structure? For most sophisticated investors, given they were making the adjustments in their valuation analyses, probably not.

The IASB Leasing Standard

Ten years ago, the FASB and the IASB embarked on a joint project to improve the financial reporting of leasing activities with the intention of responding to requests from investors and other financial statement users for a more faithful representation of an organization's leasing activities. As stated earlier, the IASB issued its new standard on lease accounting 45 days before the FASB released its standard. The IASB's approach to lease accounting differs from the FASB's in that it requires classification of all leases as finance leases, thus removing its prior distinction between operating leases and finance leases. This is a significant difference that can lead to major changes in a company's processes and systems if it has a significant number of operating leases.

Summary

The FASB's new leasing standard is finally a reality. The good news is that transitioning to it won't be as difficult a process as the revenue recognition standard. While there are some nuances to consider, preparers won't need to relearn the basic accounting for leases and much of the present infrastructure supporting the accounting remains intact. That said, organizational personnel need to familiarize themselves with the new standard and get educated as to its impact on the reporting of financial position, statement of earnings, cash flow and required disclosures. Getting the transition process started early will enable management to develop an efficient and timely plan and provide sufficient lead time to enhance processes, upgrade support systems, and prepare stakeholders for the coming change. More importantly, management needs to begin formal assessments of the potential impact of the new standard because, sooner or later, senior executives, directors, investors and other stakeholders will want to know.

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