Proposed Changes to Lease Accounting

Presented by CohnReznick’s Government Contracting Industry Practice

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AGENDA

- Brief Background on Lease Accounting
- Current Status of Proposed Changes
- Overview of Proposed Changes:
  - Scope Issues
  - Lessee Perspective
  - Quick Look at Lessor Perspective
  - Transition Guidance
- Potential Impacts / Actions to Consider
Brief Background on Lease Accounting
CURRENT GAAP FOR LEASES – “BRIGHT LINE” TESTS

Current GAAP (FASB ASC 840, formerly FASB 13) relies primarily on four “bright line” tests to determine whether a lease is considered to transfer the risks and rewards of ownership:

• Does the lease transfer title to the lessee by the end of the lease term?
• Does the lease contain a bargain purchase option?
• Does the lease term equal or exceed 75% of the property’s estimated economic life? *
• Does the PV of the minimum lease payments equal or exceed 90% of the property’s FV? *

* These criteria are not taken into consideration if the lease term begins within the final 25% of the leased property’s estimated economic life
WHERE HAVE THE BRIGHT LINES LED? (WHAT’S YOUR BEST GUESS)?

In a June 2005 SEC report on off-balance sheet activity, what percentage of future public-company lease commitments did the SEC estimate were being accounted for using operating lease accounting:

- 43%
- 67%
- 84%
- 97%
“My personal view is that (existing) lease accounting rules provide the ability to make sure that no leases go on the balance sheet. Yet you have the asset and an obligation to pay money that you can’t get out of.” If companies don’t want to capitalize the assets on their balance sheets, “then something is wrong.”

Robert Herz, Former FASB Chairman

“A balance sheet that presents an airline without any aircraft is clearly not a faithful representation of economic reality.”

Sir David Tweedie, IASB Chairman

Source: CFO, August 2005
PERCEPTIONS ON WHY CHANGES ARE NEEDED

• Perception that current bright-line rules allow for structuring of lease transactions to achieve a desired result. Small differences in the structure of lease transactions can lead to significantly different accounting results.

• Perception that current rules, and the off-balance sheet treatment they often lead to, do not meet the needs of financial statement users and are not consistent with the conceptual framework.
TIMELINE ON LEASE ACCOUNTING PROJECT

July 2006: FASB and IASB announce a joint project on lease accounting as part of their Memorandum of Understanding on convergence of U.S. accounting standards and international accounting standards

March 2009: FASB and IASB issue a Discussion Paper - Leases, Preliminary Views

August 2010: FASB and IASB issue Exposure Draft (ED) – Leases

Current Status: FASB & IASB evaluating ED comment letters and re-deliberating, with the expectation of issuing a final standard sometime in 2011. Effective implementation date not yet known, speculation is 2014 or 2015 (but with retrospective application requirements included)
Current Status of Proposed Changes
CURRENT STATUS: RE-DELIBERATION AND ADDITIONAL FOCUSED OUTREACH

FASB and IASB (the Boards) received significant feedback to the Exposure Draft during the comment period (approximately 800 comment letters) which has led to the Boards’ decision to re-deliberate several aspects of the Exposure Draft and to perform additional focused outreach (roundtable meetings, etc.) with interested parties before the final standard is issued.
Among the public comment letters received by the FASB was this one sentence missive:

“If the desired effect is to burden businesses with unnecessary business expenses, reducing their profitability, as well as (to) limit facility expansion resulting in decreased real estate taxes, then please press on!”
FOCUS AREAS FOR RE-DELIBERATION

As a result of the Boards’ evaluation of comment letters, roundtable meetings, etc., the following have emerged as focus areas for re-deliberation:

- Re-evaluating the guidance on lease terms and variable lease payments
- Definition of a lease (lease versus service components)
- Reconsidering the Exposure Draft’s front-end loading effect on P&L recognition
- What to do with lessor accounting?
WHERE THINGS STAND RIGHT NOW - STILL A WORK IN PROGRESS

Updates published by the Boards during early 2011 indicate that they have reached tentative decisions to modify some elements of the Exposure Draft guidance.

In areas where changes to the Exposure Draft are anticipated, effort has been made to include those expected changes in this presentation. Please be aware that additional changes may ensue as the Boards continue to re-deliberate and conduct outreach as they work toward a final standard. The Boards may decide to “re-expose” some or all of the proposed changes prior to issuing a final standard.
Overview of the Proposed Changes To Lease Accounting
SCOPE ISSUES

The Exposure Draft defines a lease as a contract in which the right to use a specified asset (the underlying asset) is conveyed, for a period of time, in exchange for consideration.

The Exposure Draft scopes out certain contracts / leases, including:

- Contracts that represent a purchase or sale of the underlying asset
- Contracts that transfer control of the underlying asset and all but a trivial amount of the associated risks and benefits
- Contracts that contain a bargain purchase option will generally be considered to transfer control
- Leases of intangible assets, biological assets, and leases to explore for or use natural resources (oil, gas, minerals)
SCOPE ISSUES (CONT.)

If a Contract Includes a Lease Component and Service (Non-Lease) Components:

If the purchase price of each component is observable, lessees would allocate payments between the lease component and the non-lease component based on the relative purchase price of the individual components.

If the purchase price of the service (non-lease) components are not observable, then the lessee should account for all of the payments as a lease.
SCOPE ISSUES (CONT.)

Additional guidance is anticipated in the final standard regarding the following components of many real estate leases:

- Common Area Maintenance
- Real Estate Taxes
- Operating Expenses
SCOPE ISSUES (CONT.)

The following are within the scope of the Exposure Draft, but exceptions may apply:

- Short-term leases (defined as leases with a maximum possible lease term at inception, including options to renew or extend, of not more than 12 months)

  Looks like lessees and lessors may be able to elect out of the proposed changes for short-term leases (accounting policy choices would be made for classes of underlying assets)

- Lessor accounting on leases of investment property
LESSEE PERSPECTIVE
NEW VIEW OF LEASE TRANSACTIONS

New lessee right (asset) created - right-of-use of asset being leased

New lessee obligation (liability) created - obligation to make lease payments
BIG PICTURE FOR LESSEES

• Operating lease accounting will no longer be available

• Balance Sheet Impact: Lessee will recognize a right-of-use asset and a liability for the obligation to make lease payments

• P & L Impact: Timing and classification of lessee’s P & L recognition may differ from current operating lease accounting depending on whether the lease is a “finance” lease or an “other than finance” lease

• Added complexity: Initial implementation may be time intensive depending on the magnitude and complexity of an entity’s leasing activities

• Traditional metrics and ratios may be impacted, may affect debt covenants and other agreements
LESSEE PERSPECTIVE: INITIAL MEASUREMENT OF LEASE LIABILITY

The liability for the obligation to make lease payments (the lease liability) will be initially measured at the present value of the lease payments over the lease term discounted using:

If available, the rate the lessor charges the lessee

OR, if that rate is not available, then

The lessee’s incremental borrowing rate (the rate of interest that the lessee would have to pay, at the inception of the lease, to borrow over a similar term to purchase a similar asset)
INITIAL MEASUREMENT OF LEASE LIABILITY – DETERMINING THE LEASE TERM

With respect to whether renewal options should be factored into the lease term when measuring the lease liability, it looks like the ED’s “more likely than not to occur” threshold will change. The Boards received strong negative reaction in the comment letters to the “more likely than not to occur” threshold, and the related complexity involved in that determination.

Expected change: Renewal options will be included in the lease term only if there is a “significant economic incentive” to renew the lease and reassessment will be required only when there is a significant change.
INITIAL MEASUREMENT OF LEASE LIABILITY – PRESENT VALUE OF LEASE PAYMENTS

With respect to which variable lease payments should be included in the determination of the lease liability, the Boards received negative feedback to the Exposure Draft’s probability-weighted “expected outcome” approach and have tentatively decided to simplify (yeah!) and move away from the probability expected outcome approach.
The Boards have tentatively decided that the lessee’s lease liability should take into account the following variable lease payments:

- Lease payments that depend on an index or rate (i.e. CPI adjustments)
- Expected payments under residual value guarantees included in the lease
- Term option penalties in certain circumstances
- Purchase options, if there is a significant economic incentive to exercise the option
INITIAL MEASUREMENT OF RIGHT-OF-USE ASSET

The lessee’s right-of-use asset is initially measured at the inception of the lease as:

Lessee’s lease liability + Initial direct costs incurred by the lessee

Entry at commencement of lease:

Dr  Right-of-Use Asset
    Cr  Lease Liability
    Cr  Cash or A/P for Initial Direct Costs Incurred
SUBSEQUENT ACCOUNTING FOR LEASE LIABILITY

Following the commencement of the lease:

- Lessee’s lease liability is accounted for at amortized cost using the interest method.

- Lessee must reassess the carrying amount of the liability if facts and circumstances indicate that a significant change has occurred:
  - Reassessment of the length of the lease term
  - Reassessment of the expected amount of variable lease payments
SUBSEQUENT ACCOUNTING FOR THE RIGHT-OF-USE ASSET

Following the commencement of the lease, the lessee’s right-of-use asset should be accounted for as follows:

- First, use IAS 17 guidance on leases to determine whether the lease is a “finance” lease or an “other than finance” lease. Finance leases transfer substantially all of the risks and reward of ownership to the lessee.

Factors to consider in identifying a finance lease under IAS 17:

Does the lease transfer ownership of the asset at the end of the term?
Does the lease contain a bargain purchase option?
Does the lease term comprise the major part of the asset’s economic life?
Do the present value of the lease payments at inception amount to substantially all of the asset’s fair value?

Does this sound familiar??????
For finance leases, amortize the asset over the shorter of the lease term or the useful life of the underlying asset using a method consistent with existing guidance on amortization of intangible assets. For P&L purposes, present amortization of right of use asset and interest expense separately.

For other than finance leases, amortize the asset in a manner that brings total lease related expense (the interest and amortization elements combined) into a straight-line recognition pattern. Present expense as one line item within operating expense (i.e. rent expense)
Additional guidance regarding subsequent accounting for the right of use asset:

- Asset is subject to impairment testing consistent with existing guidance on evaluation of impairment of intangible assets subject to amortization

- Asset may be adjusted if the carrying amount of the lessee’s lease liability is reassessed and adjusted
LESSEE PERSPECTIVE: FINANCIAL STATEMENT PRESENTATION

Balance Sheet: Right-of-use assets will be presented within PP & E (separately from owned assets)
Lease liabilities will be presented on the balance sheet separately from other financial liabilities

Income Statement: Presentation will depend on whether the lease is classified as a “finance” lease or as an “other than finance” lease

Footnote Disclosures: Will be more expansive, including explanations of judgments, assumptions and estimates
Example of Lessee Accounting
Lessor Perspective
BIG PICTURE FOR LESSORS

• The comment letters received by the Boards indicated dissatisfaction with the proposed changes to lessor accounting outlined in the Exposure Draft, particularly with respect to the “performance obligation approach.”

• Currently unclear where re-deliberation will lead to on the lessor side. The Boards tentatively decided at a recent meeting that there should be two accounting approaches for lessors, using guidance similar to IAS 17 to determine which approach to apply. Lessor accounting is subject to change as the Boards continue to re-deliberate.
BIG PICTURE FOR LESSORS

- Lack of clarity as to where lessor accounting is headed right now. Tentative decision at recent meeting would seem to indicate that the Boards may not move forward with the lessor accounting models included in the Exposure Draft (i.e. the performance obligation approach and the derecognition approach).

- IAS 17 accounting approaches for lessors (referenced at a recent meeting of the Boards) include finance leases and operating leases.

- Proposed changes may affect tenant behavior (buy versus lease?, shorter term leases?)

- Exceptions for lessors in the Exposure Draft:
  - May elect out for short-term leases
  - Leases of investment property accounted for at fair value under IAS 40 (or, presumably, under the anticipated U.S. GAAP equivalent)
LESSOR PERSPECTIVE: MORE ON INVESTMENT PROPERTY EXCEPTION

• Investment Property: Defined in IAS 40 as “property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for: (a) use in the production or supply of goods or services or for administrative purposes; or (b) sale in the ordinary course of business.”

• If investment property is accounted for at fair value under IAS 40 (currently optional), then the lessor accounting requirements in the Exposure Draft would not apply.
Transition Guidance
The date of initial application is the **beginning of the first comparative period presented** in the reporting entity’s first financial statements in which the new lease accounting rules are implemented. Treat as if the new rules had been applied from the beginning of the earliest period presented.
TRANSITION GUIDANCE FOR LESSEES

At the date of initial application lessees will recognize:

A lease liability for the obligation to make lease payments for each outstanding lease, measured at the PV of remaining lease payments, discounted using the lessee’s incremental borrowing rate on the date of initial application.

A right-of-use asset for each outstanding lease measured at the amount of the related liability, net of any adjustment for impairment and net of adjustment for prepaid and accrued rent at the date of initial application.

No measurement changes required with respect to existing capital leases with no options, contingent rentals, RV guarantees or term option penalties.
POTENTIAL IMPACTS

Will the proposed changes to lease accounting drive future decision making and strategies?

Buy versus lease?

Shorter term leases?

If tenants push for shorter term leases in order to minimize the liability they will have to recognize, what effects might this have?
POTENTIAL IMPACTS TO LESSEES THAT CURRENTLY HAVE OPERATING LEASES

Ratios and metrics used in assessing creditworthiness and often included in loan covenants will be impacted by the proposed changes, such as:

- Debt to Equity Ratio
- Working Capital and Current Ratio
- Coverage Ratios
POTENTIAL IMPACT TO LESSEES (CONT.)

Following issuance of the Exposure Draft, there were concerns about potential significant increases in EBITDA as a result of rent expense being replaced by amortization and interest expense on finance leases. EBITDA is often used as a valuation metric and may also be used as a metric for key employee compensation. Concerns over the impact on EBITDA have abated somewhat with the Boards tentative decision to allow for lessees with other than finance leases to treat the expense as rent expense.

There were also concerns regarding the impact of an increase in interest expense on government contractors and grant recipients in terms of cost recoverability. These concerns have also abated somewhat with the tentative decision on P&L treatment of other than finance leases.
POTENTIAL IMPACT TO LESSEES (CONT.)

Added accounting complexity and cost, including:

- Initial data-gathering, analysis and implementation may be time-consuming for entities with numerous leases (judgments and assessments may be necessary on each outstanding lease, existing systems for accounting for leases may need to be replaced or updated)

- Additional book-to-tax differences may be introduced (no indication to date that the tax treatment of leases will be changing in conjunction with the proposed GAAP changes)
POTENTIAL IMPACT TO LESSORS

If the changes in lease accounting result in a shift in market demand toward shorter term leases, what effect will that have on:

• Credit and capital flow to the real estate industry?

• Costs (more lease turnover may increase costs, increase rents)?

• Shorter lease terms may reduce real estate valuations? (which may take on increased importance if, as anticipated, investment property will soon be required to be accounted for at fair value under U.S. GAAP)
ACTIONS TO CONSIDER

Stay Informed!

Initial Assessment Now:

- Review potential impact and options with management and outside accountants
- Consider a rough, simplified “as if” analysis of impact on financial statements and important ratios and metrics. Make an initial assessment of the potential impact on loan covenants and other agreements.
- Consider initiating discussions with bank and other appropriate stakeholders
ACTIONS TO CONSIDER (CONT.)

Moving forward:

- Monitor status of finalization of the standard and re-assess as needed. Ongoing training and consultation with outside accountants.
- Analyze potential impact on loan covenants and other agreements, pursue modifications as considered necessary well ahead of implementation date.
- Begin inventorying leases and developing processes for compliance with proposed changes and establish a timetable for implementation efforts.
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