Preparing to Comply with New FASB/IASB Lease Accounting Standards

There has been a ton of talk, and articles published on this subject. We all now are aware of what's coming and when. Here is a concise summary of what you need to know and do to comply and get ahead of the curve.

EXECUTIVE SUMMARY

Preparedness is the key

The intent of the new standards is to improve financial reporting about leasing transactions and in so doing gain greater transparency for investors and other stakeholders. The FASB updates (ASU 2016-02) will take effect in two stages: for public companies the updates will take effect for fiscal years, and related interim periods, **beginning after December 15, 2018**. For all other organizations, the updates will take effect for fiscal years **beginning after December 15, 2019**. IASB changes (IFRS 16 Leases) will be implemented **for periods after January 1, 2019**. (It should be noted that early adoption is allowed and may be exercised for certain industries).

There are other points of differentiation between the new FASB and IASB standards; primarily the use by the former of a dual lessee accounting model and the latter's use of a single-lessee approach. Nevertheless, both will require assets and liabilities to be recognized when the deadlines arrive, and much information not a part of previous accounting standards will now be required.

This makes it clear, then, that in the months prior to the above dates, there is work to be done. A major part of this process will be a review and categorization of all leases, as well as their terms and options. While this might seem obvious, it may not be to all, even among very large, global companies.

The new standards also require a coordinated effort of internal departments to ensure that corporate policy concerning the standards is sound and all appropriate information is captured, centralized and archived.

FASB/IASB CHANGES THE LEASE ACCOUNTING LANDSCAPE

New rules of the road

According to FASB chair Russell G. Golden, the new guidance "ends what the US Securities and Exchange commission and other stakeholders have identified as one of the largest forms of off-balance sheet accounting, while requiring more disclosures related to leasing transactions."

In reality, what is characterized as a joint initiative had its points of disagreement and debate. Just one example was the treatment of leases as debt.

There may be obscure exceptions, but "most places in the world, except for the US, have historically counted all lease obligations as debt," says Russell Burton, 2017 chair of IAMC. "In the US, we've been allowed to show FASB-defined operating leases on the P&L as a payment, like the light bill, with only financial footnotes clarifying the underlying longer-term obligations."

"To put it plainly, this is a very big deal. In fact, a March 1, 2016 Bloomberg BNA article reported that "In the US, public companies' operating leases carried off-balance sheet amount to more than $1 trillion in leasing obligations", and a Wall Street Journal article at the time estimated the total impact to be as high as $2 trillion.

As the Bloomberg article also reported, "FASB will require enhanced disclosures. Those feature qualitative and quantitative reporting in footnotes to financial statements". The implications are massive.

THE NEW REQUIREMENTS

12 key provisions

According to financial consulting firm Deloitte, there are basically 12 key provisions of both the FASB ASU and IFRS 16. Following is a breakdown of those provisions, offered as a guideline to the changes. These are not intended for use without further input from in-house stakeholders.

1. The Scope of the FASB standards encompasses leases of all property, plant and equipment — with exceptions that include biological assets, inventory and assets under construction. IFRS 16 encompasses leases of all assets not limited to PP&E.

2. Both Boards indicate that lessees can recognize payments on a Short-Term Lease on a straight-line basis over the lease term — much like an operating lease currently. The leases would not appear on the balance sheet. Both also define a short-term lease as 12 months or less with no purchase option. Only FASB includes the phrase, "purchase option that the lessee is reasonably certain to exercise."

3. Both boards share the same essential Definition of a Lease, which is a contract, or part of a contract, that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration. That asset is referred to as the "identified asset" in the FASB terminology; while it is the "underlying asset" for IASB. There are other nuances within that overarching definition, including that a leased asset must be "specifically identifiable, either explicitly or implicitly"; that substantive substitution rights will need to be considered; that a distinct portion of a larger asset could serve as a specified asset (such as a single floor in a building); but that a capacity portion of a larger asset — such as part of a storage tank — will not so serve; and that the contract conveys control of that asset over the specified time. This, however, requires that the customer have both the right to obtain all of the economic benefit and the right to direct its use.

4. While generally accepted accounting principles in the US (GAAP) do not provide a specific exemption for Leases of Low-Value Assets, FASB does embrace a reasonable capitalization policy under which the entity will not recognize assets and liabilities below a certain threshold. IASB uses much the same language but adds that it will recognize low-value leases on a straight-line basis. IASB doesn't define low-value, although in deliberation, "the Board referred to assets of $5,000 or less."

5. For the purposes of Lessee Accounting, the lessee recognizes a liability for its lease obligation and "an asset for its right to use the underlying asset (i.e., the right-of-use or ROU asset) equal to the lease liability, adjusted for lease payments made at or before lease commencement, lease incentives and any initial direct costs. The effective interest rate method will be used to account for the liability. FASB employs two methods for amortizing ROU assets: Under the finance lease approach, the asset is amortized on a straight-line basis, with separate lines for interest and amortization on the income statement. The operating lease approach results in a straight-line expense profile presented as a single line item in the expense statement. IASB embraces an approach similar to FASB's finance lease methodology.

6. The new standards largely retain current Lessor Accounting approaches for operating and capital leases, but FASB warns that a dealer's profit may be recognized either upfront or on a deferred basis, depending on that classification. IASB will recognize dealer profit upfront.

7. Lease Term is defined as "the non-cancelable period in which the lessee has the right to use an underlying asset together with optional periods for which it is reasonably certain that the lessee will exercise the renewal option or not exercise the termination option or in which the exercise of those options is controlled by the lessor." Lessees will be required to reassess the lease term after lease inception if (1) there is a significant event or change in circumstances that is directly attributable to the actions of the lessee, (2) a contract term obliges the lessee to exercise (or not exercise) an option to extend or terminate the lease, or (3) the lessee elects to exercise (or not exercise) an option to renew or terminate

the contract that it had previously determined was not reasonably certain to be exercised. Finally, "A lessor is not required to reassess the lease term unless the lease is modified and the modified lease is not a separate contract."

8. Lease Payments include fixed and variable payments that are based on a rate or index (e.g., CPI index); amounts owed under residual guarantees (for lessees) and amounts at which residual assets are guaranteed by a lessee or by a third party (for lessors); and payments related to renewal or termination options. Note: Lease payments do not include variable payments based on usage or performance of underlying assets. For FASB, variable payments will be reassessed when the lease obligation is reassessed. IASB will reassess "whenever there is a change in contractual cash flow."

9. Lessees use the Discount Rate "charged by the lessor if the rate is readily determinable," and if not, an incremental borrowing rate as of the commencement date is used.

10. Lease Modifications refer to any change to terms and conditions. The lessee accounts for modifications as a separate contract when the change "grants the lessee an additional ROU asset" and the price of that asset is commensurate with its standalone price. Lessees would account for a lease modification that is not a separate contract by using the discount rate as of the modification effective date to adjust the lease liability and ROU asset for the change in the lease payments.

11. The Boards differ slightly in their classifications of a Sublease, FASB recommending classification based on the underlying asset of the head lease and IASB using the ROU asset.

12. A Sale/Leaseback Arrangement is not considered a sale by FASB if it does not qualify as a sale under ASC 606 or the leaseback is a finance lease. If it does qualify as a sale, the entire gain would be recognized. For IASB, a sale/leaseback will not qualify as a sale if it does not qualify under IFRS 15. Gains of qualifying sales will be limited to "the amount related to the residual portion of the asset sold." FASB sets down specific conditions determining when a repurchase option results in a failed sale, while IASB always treats a repurchase option as a failed sale.

PREP STEP-BY-STEP

The real estate department at your company will most likely not take the lead in complying with the new FASB/IASB standards. However, much of the needed information for real estate leases will generate from that department (or an outside, trusted advisor) and, as the prior section implies, much of that information may not be readily at your disposal. Interestingly, our studies indicate that there are quite a few large public companies that don't have abstracts written on each of their leases or justifications and rationales behind their options. The following steps will go a long way in getting your company ready:

1) Corporate real estate teams should get together with their company's controller and CFO to make sure they're aware of this ruling and are are developing what corporate policy will be, because it's not real estate that sets the guidelines on how this is reported.

2) The next step is to determine what will be considered a straight lease or one embedded in another contract, such as a 3PL or service contract. If it is a specific, physically distinct asset that cannot be substituted by the supplier, and the lessee has control over the asset for the term of the contract and gains all of the economic benefits, it is a lease in the eyes of the new standards.

3) Classify ***ALL*** of your leases. Everyone in finance and accounting has different rules as to what is an immaterial or "low value" lease (these don't need to be capitalized). Next is determining if it's considered a "finance" or an "operating" under the new guidelines. Does ownership transfer at the end of the lease? Are bargain purchase options reasonably certain to be exercised? Is it a specialized asset with no alternative use to the lessor? These are just some of the questions you need to ask in order to classify a lease properly.

4) Capitalization components: For net leases, only the base rent is needed in the capitalization calculation. For full service or modified gross leases in addition to the rent, the real estate taxes and insurance should

be included within the capitalization calculation. A key component of the new rules is that capitalization begins at occupancy or when the Lessee has beneficial control of the asset and not necessarily at the commencement date of the lease.

5) Considering option policies: The next question concerns capitalization on option policies, such as termination, renewal and expansion options. Answers to these questions obviously will depend on the lease's classification as a finance or operational lease.

6) Documentation & Record Keeping: Each of the above protocols demands record keeping. This includes abstracts, preferably with identified authors, for all lease documents; written justifications for rent and option escalations.

7) Reassessment triggers: Ongoing controls will be a part of the compliance process. Have you made significant capital investments since the last assessment? Have you made significant customizations since then? Have you renegotiated any terms? Documentation throughout is key to successful compliance.

CONCLUSION

How successfully and promptly each corporation addresses the coming changes at the hands of FASB and IASB is dependent on many factors:. The corporation's internal infrastructure; the proactive stance of the heads of finance and even the C-Suite will all be vital to success and compliance.

Start defining now what you need to know, or get caught short at the 11th hour.

This overhaul is going to ripple through your entire organization, so it's vitally important to get out in front of it. The time to act is now.

Need help transforming your company's real estate portfolio into a strategic contributor to your business plan? Call Mike for a free consultation.

Mike Maroon, SIOR is the Managing Partner of The Acclaim Group, a leading real estate adviser to corporations locally, nationally and globally.