FASB Lease Accounting Project

BKD LLP
CPAs & Advisors

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Background

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- FASB & IASB (Boards) joint project on leases
  - Addresses criticisms of current lease model
  - Primary objective is to **get leases on balance sheet**
  - Attempts to match US and international accounting
- Who is affected?
  - Any entities that issue GAAP financial statements
  - Will not impact tax-basis financial reporting entities
  - Applies to both real estate and equipment leases
- **Initially exposed in 2010, and will be re-exposed** in **Q2 2013 to accommodate public comments**

Current Accounting

- Most leases are operating leases
  - Expensed recognized on straight-line basis and no liability or asset recorded
  - Lease/rent expense is recorded on the income statement
- Certain leases are "capital leases"
  - Recognize an asset and liability
  - Depreciation and interest on the income statement
  - Must meet one of four tests
    - Bargain purchase
    - Transfer of ownership
    - Lease is for 75% or more of the useful life of the asset
    - Present value of lease payments is 90% or more of the fair value of the leased asset at inception

Right of Use Model

- Lease contract is one in which right to control use of asset (for period of time) is transferred to lessee

Overview of Proposed Rules

- “**Right of use**” concept
- Most leases would be recognized on balance sheets of lessees
  - Lessors will be affected in certain situations
- Lessees & lessors would use similar criteria based primarily on nature of underlying asset to distinguish between two types of leases
- Income & expense recognition patterns would be based on lease classification
- Allows current operating lease accounting for short-term leases (max. term < 12 mos.) including all possible renewals

Key Definitions and Terms

- Lease term
  - The non-cancellable portion of the lease, plus all periods for which there is a significant economic incentive to renew
- Lease payments
  - Base rental payments
  - Termination payments
  - Residual value guarantees
  - Escalating payments
  - Contingent rentals
  - Initial direct costs
  - Separation of service costs in gross leases

Key Definitions and Terms

- Discount rate
  - Lessee – rate charged by the lessor, if known, or the lessee's incremental borrowing rate
  - Lessor – Use the present value factor implicit in the lease
- Transition/Grandfathering
  - Leases will not be grandfathered, requiring a significant adjustment to financial statements upon adoption of the standard

Lessee Model

- All leases (except short-term leases) will be recognized on balance sheet
  - Right-of-use asset
    - Initially measured at present value of lease payments, plus initial direct costs
  - Liability
    - Measured at present value of lease payments

Lessee Model

- Dual model for income statement recognition
  - Some lessees will apply **accelerated** expense recognition
  - Some will apply **straight-line** expense recognition
- Recognition approach depends on level of consumption of underlying asset
- Practical expedient will apply based on nature of underlying asset (property versus nonproperty, such as equipment)

Lessee Model

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- Leases of **property** (defined as land, building or part of building or both) will be accounted for using **straight-line** expense recognition approach, unless
  - Lease term is for major part of asset's economic life, or
  - Present value of fixed lease payments accounts for substantially all of the fair value of underlying asset
- There will likely not be a bright-line test in the final rules
  - Economic realities will need to be considered in addition to standard useful life arguments.

Lessee Model

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- Leases of assets other than property, such as **equipment**, will be accounted for using **accelerated** expense recognition approach, unless
  - Lease term is insignificant portion of economic life of underlying asset, or
  - Present value of fixed lease payments is insignificant relative to fair value of underlying asset

Accounting Example

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		Accelerated Lease				**Straight-line Lease**		
	Lease Liability	**Interest Expense**	**Amortization Expense**	**Total lease Expense**	**ROU Asset**	**Lease Expense**	**Change in ROU Asset**	**ROU Asset**
Initial	33,000				33,000			33,000
Year 1	24,398	1,398	11,000	12,398	22,000	12,000	10,602	22,398
Year 2	13,431	1,033	11,000	12,033	11,000	12,000	10,967	11,431
Year 3	-	569	11,000	11,569	-	12,000	11,431	-
		3,000	33,000	36,000		36,000	33,000	

Assume a three year lease with payments of $10,000, $12,000 and $14,000 per year. The fair-value of lease payments at the start of the lease is $33,000.

Lessor Model

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- Similar to lessee accounting, Boards are proposing two types of approaches in lessor model
  1) Receivable & residual approach &
  2) Approach similar to today's operating lease accounting
- Criteria for determining approach is same as for lessees, *i.e.*, based on underlying consumption concept with practical expedients

Receivable & Residual Approach

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- Apply when lessee consumes more than insignificant portion of leased asset
- Typically presumed for leases of **equipment**, but may apply to long-term real estate leases
- Under this approach, lessors will
  - Derecognize entire carrying amount of leased asset
  - Recognize lease receivable, measured at PV of lease payments
  - Recognize residual asset, measured as allocation of carrying amount of underlying asset
  - Recognize up-front profit on transfer of right-of-use
  - Over term of lease, recognize interest income on receivable & residual asset

Approach Similar to Operating Lease Accounting

- Apply when lessee <u>does not</u> consume more than insignificant portion of leased asset
- Typically presumed for leases of **property**
- Under this approach
  - Underlying leased asset remains on lessor balance sheet
  - Rental revenue recognized on straight-line basis

Impact of Revised Lease Model

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- Impact on lessees
  - Key balance sheet metrics such as leverage & capital ratios would change
  - Lease expense recognition pattern would be accelerated for some leases, resulting in changes in certain income statement metrics such as EBITDA
  - Debt covenants & borrowing capacity may be affected
- Impact on lessors
  - Financial statements & related metrics could be significantly altered, *e.g.*, up-front profit recognition for certain equipment leases and for certain long-term building leases
  - May result in changes to business practices

Example of EBITDA Impact

	Current Accounting	Proposed Accounting	
Revenues	$ 10,000,000	$ 10,000,000	
Expenses			Lease Terms -
Salaries	3,500,000	3,500,000	- 20 year lease
Other Expenses	3,000,000	3,000,000	- $1,000,000 rent/year
Rent Expense	1,000,000	-	- 5% Interest Rate
	7,500,000	6,500,000	- Initial Fair Value of lease is $12,500,000
EBITDA	2,500,000	3,500,000	
Other Expenses			
Taxes	400,000	400,000	
Interest	500,000	1,123,111	
Depreciation	1,000,000	1,625,000	
	1,900,000	3,148,111	
Net Income	$ 600,000	$ 351,889	

Planning Opportunities

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- Impact on EBIDA
  - Adoption of this standard will typically cause EBIDA to increase for accelerated leases, which may impact employee compensation agreements or financial covenants
- Impact on Debt Service Coverage
  - Debt service coverage will typically decline under the new lease model
- Impact on Debt to Capitalization Covenants
  - Debt to capitalization will typically increase
  - This covenant is often used to limit distributions to investors
- Impact on covenants that restrict new debt or purchases of capital assets

Planning Opportunities

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- Consider revising the definition of GAAP in new loan documents
  - Many lenders are including language that “freezes” lease accounting to the current FASB treatment
- Potential for a “contract” based audit
  - Some entities are modifying documents to require audits be prepared treating all leases as operating
  - Limited use restriction if this option is selected

Potential Implications

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- Will lessees opt to buy vs. lease if a key advantage of leasing (off balance sheet financing) is removed
- Some lessors will not like having to split service costs from lease payments, which may highlight profit centers
- Some lessees will seek shorter lease terms to limit the liability that must be recorded
  - Lenders may balk at short-term leases, limiting financing options
- Accounting for leases will become very complex, requiring new software and training for financial staff
  - Sub-lease implications

What's Next?

- Boards have substantially completed re-deliberations
- Concerns still exist which may lead to alternative views presented in revised ED
- **Revised exposure draft** expected in **Q2 2013**
  - 120-day comment period
  - Will they meet the goal this time??
- Issuance of final standard targeted for late 2013
- Proposed effective date has not yet been set but will likely not be before 2016