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GAAP Tweaks

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A New Standard for Lease Accounting

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On Feb. 25, 2016, the Financial Accounting Standards Board issued its long-awaited standard on lease accounting. Under the revised standard, barring very few exceptions, the right to use an asset now represents an obligation that needs to be recognized on the balance sheet of lessees. For lessors, though, there isn't much of a change from existing generally accepted accounting principles (GAAP).

The new standard is effective for fiscal years, and interim periods within such fiscal years, beginning after Dec. 15, 2018 (for public companies), and for fiscal years, and interim periods beginning the following year, beginning after Dec. 15, 2019 (for non-public companies). Companies are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach.

The International Accounting Standards Board had also published its new standard on leases earlier in January. While the two standards are not identical, many of the critical areas of former difference between the two standards have been resolved.

Key Changes from Existing GAAP

- Lessees will need to recognize a right-of-use asset and a lease obligation for almost all leases, with the exception of those with terms of 12 months or less. The right-of-use asset and lease obligation will initially be measured at the present value of the underlying lease payments. When measuring the right-of-use asset and lease obligation, optional lease periods will only be included if it's reasonably certain that the lessee will exercise the option to extend the lease or not to exercise the option to terminate the lease.
- There continues to be differences in accounting between finance leases and operating leases, the key impact being how the expense is recognized in the statement of operations. However, the definition of a finance lease has been slightly modified to make it more principles based.
- For operating leases, a lessee will continue to recognize a single lease cost generally on a straight-line basis; for finance leases (formerly known as), the interest on the lease obligation

needs to be recognized separately from the amortization of the right-of-use asset. A similar distinction follows in the cash flow statement where the entire lease payment for operating leases are shown under operating activities; however, for finance leases, the principal portion of the lease obligation is reflected in financing activities and only the interest portion is shown under operating activities.

- The accounting for lessors has been updated to align with certain changes to the lessee model (e.g. changes in certain definitions) and the new revenue recognition standard. For example, whether a lease is similar to a sale of the underlying asset depends on whether the lessee, in effect, obtains control of the underlying asset as a result of the lease and a lessor is precluded from recognizing selling profit or sales revenue at lease commencement for a lease that does not transfer control of the underlying asset to the lessee.
- While the concept of embedded leases remain, it's only recognized if the property, plant or equipment is explicitly or implicitly identified in an arrangement and the customer controls its use. This may result in fewer embedded leases being identified.
- Certain key aspects of leasing arrangements (lease term, variable lease payments, discount rates, incentives, etc.) will continue to require significant judgments. A key departure from existing GAAP is the recognition of variable rent payments based on either an index or a rate, at inception.
- Reassessment of the lease obligation is generally triggered through modification, reassessment of the lease term or subsequent resolution of a contingency associated with a variable lease payment. The re-measurement of the lease liability results in an adjustment to the right-of-use asset until it is reduced to zero, after which any remaining adjustment is recorded in the income statement.
- The guidance for sale and leaseback transactions has been modified to align with the new revenue recognition standard whereby the transfer of the asset must meet the requirement for a sale. This may result in certain transactions (e.g. real estate) to qualify under the new sale and leaseback guidance that wouldn't have qualified before and vice versa (e.g. other than real estate).

Other Implications

These changes may have a far-reaching impact regarding various aspects of a company's operations, including its financial covenants, incentive programs, lease versus buy decision making and taxes. In addition, since virtually all leases will need to be reflected on the balance sheet, companies will need to enhance their processes to capture relevant data and report their leases.

Until now, most companies track lease arrangements in spreadsheets. However, depending on the volume of leases (e.g. companies with several retail locations) and complexity, companies may need to invest in systems that interface with their financial reporting systems in order to track these leases and report them on a periodic basis.

Tax implications: While these changes do not directly impact tax laws in the U.S., they nevertheless have tax reporting consequences. For example, adoption of the new standards may create new book/tax differences thereby recognizing new deferred tax assets and liabilities. In addition, implementation of the standard may impact the computation of many state apportionment factors (for both income and franchise tax purposes) as well as the determination

of company’s franchise tax base due to the recording of the lease obligation on the balance sheet. Lastly, property taxes may be impacted for companies where the computation is based off of the balance sheet.

What Can Companies Do Now?

In short, be prepared. Companies should establish task forces to start tracking leases that are off balance sheet and identify impacts to operations and financial results. Companies also should begin to renegotiate covenants with their lenders and revisit long-term incentive programs for key employees, as well as consider the impact of the new standard prior to entering into new lease arrangements.

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