Lessee Accounting Issues

Preparing for the New Rules

By Bill Bosco, Leasing 101

The new rules were designed by the FASB to be as neutral as possible to the financial results of companies. They maintained the current risks and rewards framework for classification, separately reporting the operating lease asset and liability and kept the profit and loss and cash flow presentation unchanged. The idea was to continue to give users the information on finance leases and operating leases that they need to make decisions. In fact most of the key financial ratios and measures and debt covenants are not impacted. It was also done with the lessee preparers in mind to make compliance easier. The real issues for lessees is the work involved to transition existing leases to the new rules and to set up a process to account for new leases in the new environment.

Transition

The issue is work and lots of it. Large companies have thousands of equipment leases and certain types of lessees like retailers and banks have hundreds to thousands of real estate leases. Under the current rules all that is required for operating lease financial reporting is to report future operating lease rents in tabular form in the footnotes and the straight line average rent is reported as a P&L statement expense and the cash paid for rent is reported as an operating cash outflow in the cash flow statement. Since the future rent obligations numbers are in the footnotes, the auditing is not as rigorous as for on balance sheet items. Also the internal control process is not as big a concern.

All operating leases with original terms of >twelve months that will exist during the reporting periods in transition must be capitalized. This fact will raise the level of audit focus. The transition year for public companies is 2019. The SEC reporting rules require three years of P&L and two years of balance sheets. This means that 2017 will be the first year to report under the new rules for public companies. Private companies must transition in 2020. Private companies have no rules for comparative financial statements but it is customary to at least provide two years comparative statements and users expect at least that. To insure a successful transition to new accounting, especially where there are high volumes of transactions and complexity, companies typically run parallel systems and test results before going live with the new reporting. This means there is an immediate need for most lessees to buy a lessee lease accounting system.

The next step in the transition process is to retrieve the lease documents for all leases in existence, read the leases and extract the data needed to capitalize and account for the leases. Some calculations will be involved to arrive at the payments to be capitalized. The data that needs to be extracted from the lease documents and input into the lease accounting and management system is:

- The contractual lease term
- The timing and amount of contractual rents payable
- Options to purchase or renew must also be captured. They are included as a lease payment only if their exercise is reasonably assured, but even if they are not reasonably assured of exercise they should be captured by the lease accounting system for future use.
- Residual guarantees must be captured and assessed as to whether a payment is expected to be made. That amount (the amount that the guarantee is “in-the-money”) is included in the lease

payments to be capitalized. I see the valuation of residual guarantees as a trouble spot as lessees may have difficulty finding expected values.

- Indication of gross/bundled billed or net lease should be captured by the system:
    - If gross or bundled billed the lease and non-lease components must be separated as only the lease component is included among the payments to be capitalized. A lessee can elect not to separate non-lease components but that would result in a large overstatement of the capitalized amount.
    - To separate the components the lessee needs information that could be obtained by asking the lessor for a breakdown. If the lessor does not provide the information, the lessee can estimate the components by using available market pricing. It remains to be seem what auditors will accept as support for estimates. I see this as a major issue in both time spent, materiality and uncertainty of outcome.
- Variable rent clauses must be captured by the system
    - Rents based in an index like CPI or a rate like LIBOR must be accounted for using the spot rate at the date of booking.
    - Other variable rents are accounted for as incurred unless they are considered "disguised lease payments" (meaning the contractual rents are below market and the variable rents are reasonably assured of being incurred) and in that case an estimate must be capitalized.

Ideally the lease accounting and management system should not only capture information for booking and accounting for the leases, it should serve as a tickler file (critical date system) to warn of future events like when a lessee must give notice to the lessor. It should also be able to produce disclosure information as to a table of future rent obligations, weighted average term and weighted average discount rate.

The lessee will also have to identify any unamortized IDC, unamortized landlord allowances and any accrued rent payable associated with each lease in existence during the transition financial reporting periods. Those amounts are elements (sub accounts) of the ROU asset and should be input into the lease accounting system.

The lessee will have to choose a discount rate for each lease to calculate the present value of payments to capitalize the lease. That discount rate is the lower of the lessee's incremental borrowing rate as of the date the lease is being booked or the implicit rate in the lease (if known – it is typically only known in synthetic leases and split-TRAC leases where the lessee knows the lessor's residual assumption). Often lessees do not know their incremental borrowing rate as they do not borrow medium term fixed rate money. A proxy for the incremental borrowing rate is the lessees' revolver rate swapped to fixed using the swap rate reported in the Federal Reserve's H15 screen that most closely matches the term of the lease.

To ease the compliance burden, the FASB allows the lessee a transition relief package to continue using existing GAAP/definitions for items like IDC, lease classification and sale treatment in a sale leaseback. At this point the lessee has all the information needed book all existing operating leases.

Process for new leases

The new rules will require a new process to book leases that will involve participation of several disciplines in the lessee organization. The process and its internal controls must be documented.

The accounting department must receive and review every lease. The lease payments have to be extracted as described in the transition section above.

There are several items that require judgement of the business unit responsible for the leases:

- If they are gross/bundled billed, the business unit responsible for negotiating the lease must provide information to separate the lease and non-lease components.
- If there are any renewal or purchase options in the lease the business unit responsible for the leases must document its judgement as to whether the options are reasonably certain of exercise (and thus considered a lease payment) or not.
- If the lessee is providing a residual guarantee the guarantee must be compared to the estimated value of the asset at lease expiry to determine if there is a payment expected. That amount is a lease payment. The residual guarantee has to be reviewed for adjustment whenever the lessee issues financials to the public.

The treasury department must provide information on incremental borrowing rates to book the leases. For leases with variable payments based on an index or rate, treasury must provide information on changes in CPI and any interest rate for floating rate leases.   To ease the complexity the FASB allows a lessee to hold off on rebooking a lease with variable rents based on a rate or index where the rate or index changes the contractual rents. The lessee need only rebook when the lease is modified or when the lessee does something that changes the assumptions (the best example is incurring significant leasehold improvements that make renewal options reasonable assured of exercise). This presents an issue – do I rebook anyhow or do I track the "un-booked" variable rent changes as they must be disclosed and they must be paid and expensed.

The accounting department must classify the lease using the appropriate discount rate, the lease term and the lease payments (including interim rents and any other payments the lessor can force the lessee to pay). The accounting department must then record the lease.

The ongoing accounting is complex so a lessee accounting system is recommended with all the controls, history, report generation capability, etc. The days of managing operating lease accounting using an Excel spreadsheet are over.

Good luck lessees – it's show time in the whole new world of lease accounting.

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