CBRE

Lease Accounting Update

January 2016

IASB Issues New Lease Accounting Standard; FASB is Not Far Behind *(Really, we are not crying wolf!)*

Highlights

- The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB), collectively the "Boards", will require all leases be recognized as a liability on the balance sheet.
- The IASB issued its new lease accounting standard on January 13, 2016. The FASB is expected to issue its new standard in February. While very similar, there are key differences between the two standards.
- The effective date for the IASB's new standard is 2019, while the effective dates for the FASB standard are 2019 for public companies and 2020 for private companies.
- Leases of 12 months or less are excluded from the requirements of the new standards (both IASB and FASB), as well as "low value" leases (IASB only).
- The IASB requires all leases be classified as Finance Leases.
- The FASB has a dual approach to lease classification with two types of leases: Finance Leases and Operating Leases.
- Finance Leases, per the new standards, are accounted for in the same manner as today's Capital and Finance Leases and have a front-end loaded expense pattern.
- Operating Leases, per the new standard (FASB only), will have a straight-line Rent Expense; the same as today's Operating Leases.
- Whether a Finance or an Operating Lease, it will be recorded on the balance sheet as a Right-of-Use (ROU) asset and a lease liability.
- The ROU asset and lease liability are generally determined based upon the present value of the lease payments over the primary term of the lease.
- Renewal options are only included in the determination of the ROU asset and lease liability if they are "reasonably certain" of being exercised.
- The liability associated with an Operating Lease (FASB only) is NOT DEBT, while the liability of a Finance Lease is considered debt.
- Compared to current lease accounting, the P&L impact of the FASB's new standard will be minimal, while the IASB standard will result in the straight-line rent of today's Operating Leases being replaced with the front-end loaded expense pattern of Finance Leases.

Like the boy who cried wolf in the famous Aesop fable, such has been the story of the changes to lease accounting. The lease accounting story began in 2006 when the Boards issued a Memorandum of Understanding reaffirming their commitment to a uniform global lease accounting standard (aka "convergence"). Since then, there have been countless cries of "wolf!" over the course of this epic saga, most notably after the Original Exposure Draft was issued in August 2010 and the Revised Exposure Draft was issued in May 2013.

The primary objectives of convergence are: 1) to provide greater transparency and comparability to users of financial statements and; 2) to require the liabilities associated with leases be recognized on a company's balance sheet. While the former may be up for debate, the latter is now a foregone conclusion as the Boards have converged on requiring the recording of lease liabilities on the balance sheet. Ironically, after all this time, the Boards have failed to reach convergence on several important aspects of the changes to lease accounting. As a result, a uniform global lease accounting standard has not been achieved and each Board is issuing their own distinct "Leases" standard.

The IASB issued its standard on January 13, 2016, and the key components of the FASB's standard are well known and unlikely to change between now and February when its standard is expected to be issued. It is safe to say we are no longer crying "wolf" on this topic.

FREQUENTLY ASKED QUESTIONS

To facilitate an understanding of the changes to lease accounting, in particular as they pertain to real estate leases, the following Frequently Asked Questions (FAQ) have been prepared. As the changes to lessor accounting for real estate leases are minor, these FAQs focus on lessee accounting.

Why are changes being made to current lease accounting?

The primary goals of the new lease accounting standards are to provide greater transparency and comparability in financial reporting and to require the liability associated with a lease be recognized on the lessee's balance sheet. This is in contrast to today where only Capital and Finance Leases, representing only a small portion of the universe of real estate leases, are required to be recorded on the balance sheet.

Will the FASB and the IASB issue their own distinct standards?

Yes. Unfortunately, the Boards could not gain consensus on a uniform standard. As a result, the FASB, which regulates accounting for U.S. companies reporting under U.S. Generally Accepted Accounting Principles (GAAP), and the IASB, which regulates accounting for companies outside of the U.S. reporting under International Financial Reporting Standards (IFRS), will each issue their own distinct standard. While the standards are similar in many ways, there are a few key differences, which are addressed in this FAQ.

What companies must follow the new standards?

Companies following U.S. GAAP or IFRS reporting requirements will be required to follow the new standard issued by the applicable Board.

What is the timing for the new standards to be issued? What are the effective dates?

- IASB
  - The new standard (IFRS 16 Leases) was issued on January 13, 2016.
  - The effective date is 2019.
  - Companies can "early adopt" the new standard after they have adopted IFRS 15 – Revenue With Contracts From Customers.
  - Restatement requirements vary based upon the transition approach adopted.

- FASB
  - The new standard is scheduled to be issued in February 2016.
  - The effective date for public companies will be 2019.
  - The effective date for private companies will be 2020.
  - Companies may "early adopt" once the new standard is issued.
  - Companies must restate comparative periods in their financial statements. For public companies, this will be for two years prior to the effective date for the P&L and one year prior for the balance sheet.

What leases will be impacted by these changes?

The new standards impact ALL leases, not just real estate leases. The only exceptions, at the option of the lessee, are for:

- "Short-term" leases of 12 months or less.
- Leases of certain "low values" (IASB only). While not an authoritative document, in the Board's "Basis for Conclusions," a threshold of $5,000 is referenced. The value is based on the value of the asset as new regardless of whether the asset being leased is new or used. Examples may include small office equipment, desktop computers, etc.

Will leases in-place on the effective date be excused from following the new standard?

Leases in-place on the effective date will be subject to the transition requirements of the applicable new standard. While the variety and complexity of the transition requirements precludes an in-depth review of the topic, generally speaking, leases in-place on the effective date will be recorded on the balance sheet. The amount recorded will be subject to the specific guidance provided by each Board.

Have the Boards agreed on the type(s) of leases?

No. This is a significant area of disagreement between the Boards:

- The FASB has embraced a dual approach to lease classification for lessees and believes there are two lease types: Operating Leases and Finance Leases.
- The IASB has a single approach to lease classification for lessees and believes all leases are Finance Leases.

What is the difference between the two lease types?

Finance Leases are the same as today's Capital and Finance Leases:

- They are recorded on the balance sheet as a ROU asset and a lease liability.
- There is no Rent Expense associated with a Finance Lease; rather the expense is comprised of both Interest and Amortization/Depreciation Expense.
- Because Interest and Amortization/Depreciation Expense are reported below Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), this lease type results in improved EBITDA when compared to an Operating Lease and its associated Rent Expense.
- However, since the Interest Expense is determined using the effective interest method (i.e., similar to a mortgage where the interest component of your payment is greater in the early years), this lease type has a front-end loaded expense pattern.
- The liability associated with a Finance Lease **is considered debt**.

Operating Leases (FASB only) are similar to today's Operating Leases:

- The exception is that both a ROU asset and a lease liability must be recorded on the balance sheet.
- The expense is reported as Rent Expense and, like current accounting, will be recognized on a straight-line basis over the term of the lease.
- The liability associated with an Operating Lease **is NOT considered debt**.

Are both Operating Leases and Finance Leases, as defined in the new standards, recorded on the balance sheet?

Yes. The only exceptions are short-term leases (12 months or less) or "low value" leases (IASB only).

How will the different lease types be determined?

There is only one lease type for lessees following IFRS, so no criteria is required for determining the lease type. All leases are Finance Leases.

For companies following U.S. GAAP, the classification process will be “determined in accordance with the principle in existing lease requirements (that is, determining whether a lease is effectively an installment purchase by the lessee).”

Surprisingly, while the FASB has said from day one the new standard will eliminate the “bright line” tests as they exist in current U.S. GAAP, they have now indicated the “bright line” tests may be used as a “safe harbor” test under the new standard to determine whether a lease should be classified as an Operating Lease or a Finance Lease.

“Bright line” test refers to two of the four tests in current U.S. GAAP where specific percentages are stated and if the percentage is equal or exceeded, it triggers treatment of the lease as a Capital Lease. These tests include:

- The lease term is equal to 75% or more of the estimated economic life of the leased property.
- The present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property.

What amount will be recorded on a company’s balance sheet for leases commencing after the effective date?

The amount initially recorded on the balance sheet as both a ROU asset and a lease liability takes into account the following:

- The present value of the rent payments to be made over the primary lease term.
- Any portion of the rent attributable to the reimbursement of expenses (e.g., operating expenses, real estate taxes, etc.) can be excluded from the calculation.
- Rent paid during renewal option periods is only included if the option is “reasonably certain” of being exercised. This is consistent with the existing requirement of both Boards relative to Finance and Capital Leases. The FASB has noted this is considered a “high threshold” to meet. As a result, renewal options should not come into play very often.
- Future CPI increases, or increases based on an index or rate, are not taken into account in the initial calculation.
- The discount rate used is the lessee’s incremental borrowing rate.
- The ROU asset is adjusted for any Initial Direct Costs incurred (see definition following) and lease incentives received, if applicable.
- The ROU asset and lease liability will be fully amortized over the term of the lease; however, the methodology varies by lease type.

Is percentage/turnover rent included in the calculation of the ROU asset and lease liability?

No.

How will CPI increases, or other increases based on an index or rate, be accounted for?

For companies following U.S. GAAP, any “variable lease payments” based on an index or rate associated with an Operating Lease will be recorded as Rent Expense when incurred. These increases by themselves will not require a re-measurement (i.e., recalculation) of the ROU asset and lease liability.

For companies following IFRS, an increase in rent based on an index or rate will require the ROU asset and lease liability to be re-measured taking into account the increased rent. The ROU asset and lease liability will then be adjusted accordingly.

Are any other costs taken into account?

Yes. "Initial Direct Costs" associated with a lease must be added to the ROU asset and amortized/depreciated over the lease term. An Initial Direct Cost is defined as an incremental cost that would not have been incurred if the lease had not been executed (e.g., space planning, legal, etc.).

Under the new standards, is there a difference in the amount initially recorded on the balance sheet for a Finance Lease versus an Operating Lease?

No. The initial amount will be the same no matter the lease type. It is the amortization of the ROU asset and the lease liability over the lease term that will differ by lease type.

What will be the P&L impact resulting from the new standards?

For companies following U.S. GAAP, there will be minimal, if any, P&L impact resulting from the new standard. This is because Finance Leases will be treated the same as today's Capital Leases, while Operating Leases, under the new standard, will have straight-line Rent Expense just like they do today.

For lessees following IFRS, there will be a P&L impact for companies with Operating Leases under today's lease accounting. As all leases will be Finance Leases pursuant to the new standard; today's Operating Leases with straight-line Rent Expense will be converted to the front-end loaded expense pattern associated with a Finance Lease. While this could increase a company's EBITDA, the front-end loaded expense pattern may adversely impact the company's bottom line in the early years of a lease.

Could the new standards result in debt covenants being violated?

For companies following U.S. GAAP, this concern should be mitigated to a great extent because the FASB has specifically stated that the liability associated with an Operating Lease under the new standard will be considered an "operating obligation" and **NOT DEBT**. The liability associated with a Finance Lease is considered debt, which is consistent with today's treatment of Capital Leases.

For companies following IFRS, the new standard could cause concerns over debt covenants as all leases will be Finance Leases and the lease liability will be considered debt. The potential impact of this should be explored further by the company's accountants within the context of any existing debt covenants.

CONCLUSION

While leases will be required to be recorded on the balance sheet, thanks to the persistent efforts of the real estate industry, including CBRE, many of the most onerous requirements put forth in the Original Exposure Draft (e.g., renewal options, percentage rent, CPI increases, expense recognition, debt treatment, etc.) have now been eliminated or changed for the better. This is a significant positive development and should not be overlooked as the industry now proceeds to digest the details of the new standards.
The epic saga is coming to an end. We now find ourselves at the start of a new journey to better understand the consequences, both intended and unintended, of the new standards. The implementation of the new standards and the strategic considerations resulting from them are the next leg of the journey.

CBRE's Global Task Force on Lease Accounting will continue to provide news and updates on this topic, as well as be a thought leader for the industry. The journey continues…

For further information, visit the websites of the FASB , IASB and the CBRE Task Force.

For suggestions on what companies can do as they begin to work through the implementation phase of the new standards, please see the recommendations previously put forth by the Task Force.

For more information, please contact:

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