A Glimpse into the "New World Order" and "Understanding the New Lease Accounting Rules"

Stephen G. Austin, CPA, MBA
Swenson Advisors, LLP

March 17, 2017

Tailwinds

Source: Now that the election is over, what are the economic and investment implications of a new administration
Nancy Tengler, Heartland Financial USA, Inc.

Trump Spurs Jump In Optimism

San Diego Union Tribune| March 15, 2017

The economic expectations of the heads of the nation's largest companies jumped in the first quarter by the most in more than seven years amid optimism about corporate tax cuts, reduced regulations and a boost in infrastructure spending promised by Trump and congressional leaders, the trade group found.

The Promise and the Peril of the Trump Economy

Fortune Magazine| March 1, 2017

In Dave Cote's mind, the case for optimism is clear. The CEO of industrial giant Honeywell believes that the US economy is poised for a surge under the Trump administration. President Trump's pro-growth plan to lower corporate taxes and streamline regulation, says Cote, has energized the business world.

Headwinds

Source: Now that the election is over, what are the economic and investment implications of a new administration
Nancy Tengler, Heartland Financial USA, Inc.

In Retreat

The Economist | January 28, 2017

Mr. Trump is unusual in his aggressively protectionist tone. But in many ways he is behind the times. Multinational companies, the agents behind global integration, were already in retreat well before the populist revolts of 2016.

Observations from Heartland Financial

- Global growth is slowing. US GDP growth is slow as well – (the slowest recovery since WWII)
- With slow growth comes muted productivity growth in the US and around the world

Source: Now that the election is over, what are the economic and investment implications of a new administration
Nancy Tengler, Heartland Financial USA, Inc.

Firms Hit by Lack of Accountants

Wall Street Journal| March 6, 2017

- Amid accounting changes to the generally accepted accounting principles that governs US financial reporting, companies are scrambling to find technical accountants, regulatory experts who can understand the rules and ensure that management and staff can comply.
- The shrinking pool of available accountants is putting pressure on companies as they begin to apply new Financial Accounting Standards Board rules. The changes affect the way firms book revenue and report the value of leases held on their balance sheets. The rules don't take effect right away; <u>public companies must apply new revenue standards for fiscal years beginning after Dec. 15, 2017</u> and new lease rules begin in 2019. Still, corporations must assess and <u>revise two years of past financial reports.</u>

Press Release

Sealed Air Discusses Fourth Quarter, Full Year 2016 Results and Lease Accounting

CHARLOTTE, NC (BUSINESS WIRE) Jan. 17, 2017

"Companies will step up their efforts this year to collect necessary data on all leases in a centralized, electronic inventory (24.7%); implement multiple new accounting standards (16.3%); figure out where to start the implementation process (15%); and determine whether IT solutions currently in place for tracking lease data can manage implementation and compliance with the new standard (9.4%)."

Key Findings - Deloitte Report

Two-Thirds of US Large Companies Report New Lease Accounting Standards "More Complex Than Anticipated"

February 28, 2017

1. Companies are starting to take action with two-thirds reporting to be ahead of schedule or on-schedule. Approximately, 70% of companies have assigned a formal project manager indicating an executive-level commitment towards resourcing the project.

Key Findings (continued)

2. However, fewer than 30% have taken the next step of assigning a formal budget for the project. A noteworthy 25% of companies reported that the project has not started yet;
3. Nearly two-thirds of companies are finding the lease accounting project to be <u>more complex than originally anticipated.</u>

"With new assets and liabilities coming onto the balance sheet, it's time for preparers and practitioners to act."

Bringing Leases Into View

Journal of Accountancy

April 1, 2016

Why is the New Standard Necessary?

The old lease model was **criticized** for failing to meet the needs of users of financial statements

The SEC issues a report on off-balance sheet activities in 2005 which recommended that changes be made to the existing lease accounting

$1-2 trillion of "off balance sheet" lease commitments existed for SEC registrants

In 2006, the FASB and the IASB embarked on a joint project to improve the financial reporting of lease activities

Overview

FASB issued a new standard

Topic 842, Leases

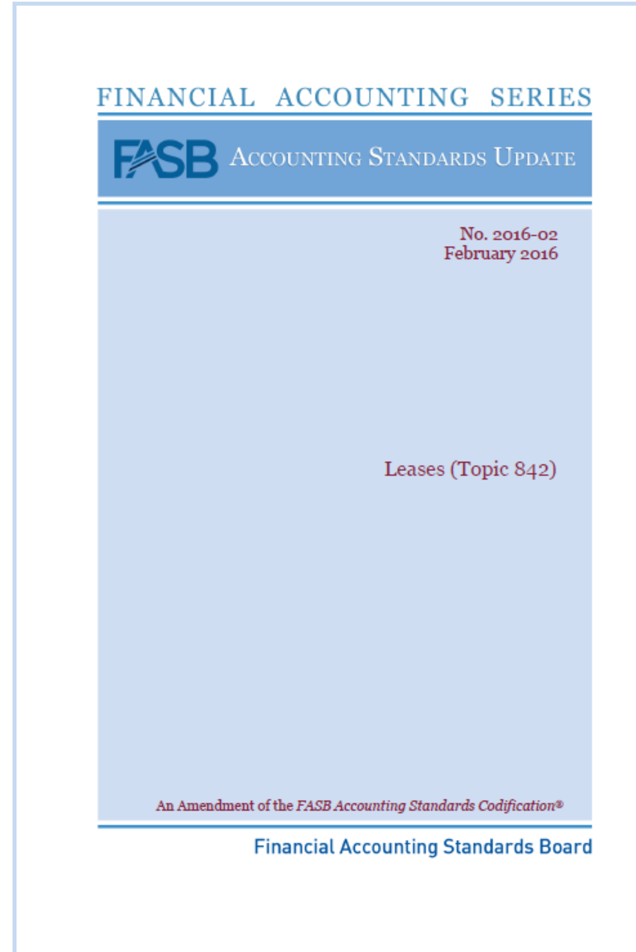
February 25, 2016

Effective for annual periods beginning **AFTER**

December 15, 2018 (public entities)

December 15, 2019 (non-public entities)

EARLY ADOPTION IS PERMITTED BY ALL ENTITIES



FINANCIAL ACCOUNTING SERIES

FASB ACCOUNTING STANDARDS UPDATE

No. 2016-02
February 2016

Leases (Topic 842)

An Amendment of the *FASB Accounting Standards Codification®*

Financial Accounting Standards Board

The Voice in Your Head…
What Do You Care About? What's Important?

What Matters Most?

Which part of your firm's financial statements do you care most about? What drives financial decision making for your firm?

Are you balance sheet or P&L driven?

If it's the P&L, is it the *entire* P&L or really just EBITDA that drives decisions?

Types of Leases

Lessor

- Sales Type
- Direct Financing
- Operating

Lessee

- Operating Lease
- Finance Lease

What is a Lease?

Lease: A contract that conveys the "right to use" an underlying asset for a period of time in exchange for consideration

To determine whether a contract contains a lease, a company should assess whether:

A. Fulfillment depends on the use of the identified asset
B. The contract conveys the right to control the use of the identified asset

Lessee: Lease Classification

Finance Lease – when **any** of the following criteria are met at lease commencement:

1. The lease transfers ownership of the underlying asset
2. The lessee is reasonably certain to exercise an option to purchase the asset
3. The lease term is for the major part of the remaining economic life of the asset
4. The present value of the sum of the lease payments equals or exceeds substantially all of the fair value of the underlying asset
5. NEW – the underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

Operating Lease – when **any** lease does not meet the criteria above

Lessee: Lease Classification (continued)

While the *bright lines* are gone:

When determining lease classification for financing leases, one reasonable approach to assessing the criteria would be:

75% or more is a major part of the remaining economic life of the underlying asset	The last 25% of the total remaining economic life of the asset	Lease value represents 90% or more of the fair market value of underlying asset

Lessor: Lease Classification

Sales-Type Lease:	Same criteria as a Finance Lease for Lessee
Direct Finance Lease:	A lease from a non-manufacturer where the sum of the present value of the lease payments and residual value equals or exceeds substantially all of the fair market value for the underlying asset
Operating Lease:	Anything not included above

Lease Accounting Model

Lessees will recognize a **"right-of-use asset"** and a **"lease liability"** for virtually all their leases.

1. The liability will be equal to the present value of lease payments. The obligation will be accounted for similar to debt and amortized using the effective interest rate method.
2. The asset will be based on the liability, plus any prepayments, initial direct costs, less incentives received, etc.

For income statement purposes:

1. Operating leases will result in straight line expense (similar to current operating leases)
2. Finance leases will result in a front-loaded expense (similar to current capital leases)

Key Information

Information Needed:

- What term do I use?
- What are the rent payments?
- Discount Rate?
- Landlord allowances?
- Initial direct costs?
- Impairment considerations?

Exactly How Long is my Lease?

- Consider “significant economic incentives”
- Understand the value, life and specialized nature of LHI
- Are there mid-term tenant improvement payments?
- Understand strategic implications to business for each deal in terms of location/purpose
- Negotiate renewal rates: stated, FMV or a % of FMV?

Things that Cause You to Re-Measure Your Lease Obligation

"Mark to Market" type accounting
Early renewals
Lease extension
Early cancellation
Expansion
Contraction
Blend & extend impairments
Rental rate negotiation
Rent tied to outside index (CPI)
Each time you receive an allowance payment from the landlord (ROU Asset Only Change)

Other Changes

Impairment

- A lessee shall assess whether a "right-of-use asset" is impaired and shall recognize any impairment in accordance with GAAP/IFRS Rules

Disclosures

- Extensive quantitative and qualitative disclosures:
  - Significant judgements made by management
  - Insight into the extent of revenue and expense recognized and expected to be recognized from existing contracts

Example: Lease Facts

What we know about the Lease

- Lessee enters into a 10 year lease
- Lease payments are $50,000 at the beginning of each year. First payment was made on commencement date.
- Lessees incremental borrowing rate is 6.8% (could not determine its implicit rate)
- The lessee incurred $25,000 of direct costs ($5,000 are legal costs)
- Lessor paid $30,000 in moving expenses on commencement date

Example: Valuation

Lease Liability

- The lessee measures the liability as $328,500. This amount equals nine payments of $50,000 discounted at 6.8%

Right-of-Use Asset

Lease liability	(see above)	$ 328,500
+First lease payment	(on commencement date)	50,000
+Initial direct costs	(less legal fees that do not apply)	20,000
+Lease incentive	(received on commencement date)	30,000
Right-of-use-asset		**$ 368,500**

Example: Journal Entry

The Lessee will record the following Journal entry to record the operating office lease at commencement date:

Debit:	Right of use asset	$ 368,500
Debit:	Legal expense	5,000
Credit:	Lease liability	$ 328,500
Credit:	Deferred initial direct costs	20,000
Credit:	Cash, net	25,000

Example: Balance Sheet

Balance Sheet	Initial
Assets	
Cash	$ 2,979,500
Right of use asset	368,500
Total assets	$ 3,348,000
Liabilities	
Lease liability	$ 328,000
Deferred initial direct costs	20,000
Total liabilities	348,000
Equity	3,000,000
Liabilities and Equity	$ 3,348,000

What's Next?

cresa
The Tenant's Advantage

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Next Steps

1. Gather information about existing leases
2. Decide whether or not to apply the practical expedients
    1. May eliminate reclassifying leases and re-measurement of initial direct costs
    2. Maybe a factor in determining the timing and extent of the transition
3. Find an effective business solution

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Sample Approach to Implementation

Develop pro-forma balance statements and income statements for 2016, 2017, 2018, and 2019

Assess effect of working capital, loan agreements, new leases, etc.

Decide on an implementation date and strategy

Monitor the IASB/FASB implementation group considerations

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