Briggs & Veselka Co.
CPAs and Business Advisors

New Lease Accounting Rules: Highlighting the Financial Statement and Debt Covenant Risk

By Kevin Stewart, Audit Senior Manager

The years 2017 through 2020 will be remembered as "the wonder years" for accountants as each year will have had significant accounting changes to taxes, revenue, and leases rolled out to both public and private entities. Combined with the once in a generation tax regulation change, and you have a whirlwind of changes to consider for both CPAs and reporting entities.

Much has been written about leases since the mid-2000's when the FASB initiated a joint project with the IASB in 2006, which was finalized in February 2016 with the issuance of Accounting Standards Update (ASU) 2016-2, Leases (Topic 842) that changed the lease accounting rules.

ASU 2016-2 becomes applicable for public companies with annual periods after 12/15/2018 or calendar periods after 1/1/19 and is applicable for non-public companies with annual periods after 12/15/19 or calendar periods after 1/1/20.

Through this project, the FASB has attempted to, and I believe, will improve the transparency and comparability of financials by recognizing leases as both an asset and a liability on the Balance Sheet, as well as provide more relevant information within the disclosures of the financial statements. In simple terms, the financial statements and the related disclosures will now match and reflect the economic transaction and related commitments.

Summary of Changes and New Concepts

The following represents a summary of changes and new concepts associated with ASC 842. The list is not necessarily comprehensive, but instead are the areas I believe the majority of companies will be impacted by.

- Right of use assets associated with operating leases are included as an asset on the lessee's balance sheet
- The present value of the lease payments, discounted using either the implicit rate (if available) within the lease or the lessee's incremental borrowing rate, is recorded as a liability on the lessee's balance sheet
- Implicitly distinct assets within "contractual agreements" can be defined as a right of use asset which would require recognition of both an asset and a liability as noted above – the "right" may result from either a supply or service contract agreement

- If multiple agreements are entered into near or at the same time, the agreements should be evaluated to determine if one "lease" exists, or multiple – if the agreements are highly dependent upon one another, that conceptually results in one agreement

- Multiple components, or right of use assets, may be included within one lease agreement and should be separated for reporting purposes – "services" included within the agreement may be required to be accounted for separately from right of use assets dependent on materiality of the service component

- A new lease classification criteria was added wherein an asset, which is highly specialized and has limited or no alternative use to the lessor, is considered a financing lease

Additional new concepts beyond the above noted changes introduced to lease accounting include:

- *Identified Assets* – defined as the specific asset(s) that is the basis or supports the contractual agreements

- *Substitution Rights* – this is specific to the exclusivity and importance of a specific asset. Is it a specific asset (helicopter, car, piece of equipment)? Or is it a comparable asset able to be substituted?

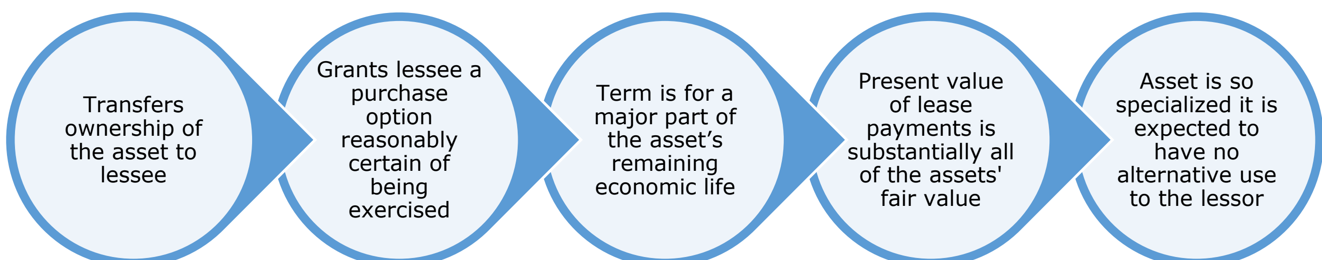
- *Right of Control* – the effective ownership of the use of the asset during a set period of time. Is the maintenance, use, and operation of an identified asset under the control of the user?

- *Separation and Allocation* – service agreements which include both a service and a right of use asset should be evaluated separately for both "materiality" and "recognition of expense." The value of lease and non-lease components should be considered independently, and relative values based on the overall agreement are required for appropriate financial statement recognition.

Based on review of the guidance, the primary impact is to the lessee; lessors are ***relatively*** un-impacted by the change in accounting guidance, they will not be discussed here. The primary focus within this article is to outline the impact of moving operating lease right of use assets and associated liabilities onto the balance sheet, discuss the completeness risks associated with embedded leases, and the "unintended consequences" of debt covenant impacts. Lastly, recommended steps on how to move forward in the process will be provided.

Capital Lease = Financing Lease

The updated guidance requires that if any of the following criteria is met, the lease is classified as a <u>financing lease</u>.



Historically, the impact of a capital lease or financing lease required the underlying asset to be recorded on the financial statements as an asset. Effectively, a capital lease was considered a form of financing or debt, and in many instances, was being included as debt for the purposes of debt covenant related ratio calculations.

If none of the above criteria is met, the lease is classified as an operating lease.

Operating Lease = Right of Use Asset and Lease Liability

Under the old standard, the benefit of an operating lease classification was that it had no impact on the balance sheet, assets, or liabilities. However, under the new guidance, operating leases will increase assets through the recognition of a right of use asset and increase the associated liability.

Below is a summary of the impact to the financial statement to lessees:

Finance or Operating	Balance Sheet	Income Statement	Cash Flow Statement
Finance	Right-of-use asset Lease liability	**Front Loaded:** Amortization Expense / Interest Expense	Financing – Principal Operating – Interest / Variable Payments
Operating	Right-of-use asset Lease liability	Lease Expense	Operating

Embedded Leases – The Completeness Risk

In order to develop an understanding of the implementation challenge that your organization might encounter, the first step in the process is understanding the current population of leases, as well as consider the risks of currently unknown embedded leases within contractual agreements.

Embedded leases exist if there is an explicit or implicit asset in the contract, and the customer controls the use of the asset. This control is the primary consideration to take into account once an asset is discovered. If an implicit lease is controlled and its primary purpose is to serve the controller's specific needs over the course of the agreement, then it is probable that an embedded lease exists. Examples include supply contracts, data center agreements, and outsourcing agreements:

- ***Oil and Gas Drilling or Pipeline Contracts*** may specify the use of equipment or pipeline. If the pipeline is primarily or exclusively transporting oil or gas to one primary recipient, then the pipeline may be considered an embedded lease with an associate right of use asset.

- ***Power Purchase Agreements*** may include the use of a specific plant. Similar to the oil and gas contracts above, if the power purchased is from one specific power plant and the majority of the electricity from the power plant is for one primary recipient, the power plant may be considered a right of use asset. This is based both on the recipient being the primary beneficiary of the plant's production which infers control over the contracted plant.

- ***Call or Shared Service Center Agreements*** may include computers, printers, copiers, and phone systems which may be considered right of use assets if the recipient is the controlling beneficiary of the services.

The above examples lead to the risk that the identified lease population is not complete due to the embedded nature of the related assets within contractual agreements.

Financial Statement Impact = Blown Debt Covenant Risk

A potential unintended consequence of the lease accounting change is the impact on debt covenants. Although the FASB took into consideration debt covenants and issued comments that operating lease commitments are not, and should not be considered debt, lenders (banks) may evaluate operating lease liabilities from a different point of view and may consider these commitments as debt.

Separately, depending on how debt covenant ratios are defined and calculated, "operating lease" liabilities could be considered debt for purposes of the calculation and would impact leverage ratios, such as:

- *Debt-equity*
- *Debt service coverage*
- *Basic fixed-charge coverage*
- *Current ratio*

In each of these instances, the ratio would be weakened due to the potential increase in defined debt with no respective change on the other side of the ratio calculation. Depending on the portfolio of operating lease liabilities brought onto the books, the impact could be material. Considering the impact of a retailer who enters into operating lease agreements for store locations, the impact of the related lease liabilities would significantly and materially impact the company's balance sheet and related ratio calculations.

Similarly, covenant ratios driven by asset values could see significant impact as well.

Return on assets = Net Income / Total Assets

Return on Capital Employed Return = EBIT / (Assets – Current Liabilities)

Asset Turnover = Sales / Average Total Assets

In each instance, unless specifically excluded from the ratio calculations within the debt agreement, newly recorded right of use assets will increase total assets, which will in turn dilute or decrease these ratios.

Excluded Leases and Practical Expedients

To expedite and simplify the process, certain agreements have been excluded from consideration, and as such, are not part of the lease transition. The following represents a partial list of excluded leases:

- *Short-term leases (defined as less than 12 months)*
- *Intangible assets*
- *Exploration for non-regenerative natural resources*
- *Biological assets*
- *Inventory*
- *Assets under construction*

Practical Expedients

Due to the identified challenges in transitioning to the new lease accounting guidance, the FASB within its initial release and the adopted amendments in late 2017 elected to provide relief to entities by allowing for a simplified transition approach. The two most impactful "practical expedients" are associate with comparative periods and "separation and allocation."

Presented Period Amendment

As companies adopt the new leasing guidance, the initially passed guidance required lessees to recognize and measure leases at the beginning of the earliest period presented in their financial statements, using a modified retrospective approach. For example, a private company lessee adopting the new leasing guidance for its year beginning January 1, 2020 would measure and recognize leases as of January 1, 2019 if comparable periods are presented.

The FASB proposed and accepted amendments allowing companies the option to apply the requirements and criteria of the new lease guidance as of the effective date (e.g., January 1, 2020), without adjusting the comparative periods presented. The proposal could simplify transition to the new guidance. For example, a lessee would not have to measure and recognize leases that expired prior to the effective date or consider the effects of each modification for leases that were modified more than once during the comparative period presented.

Separation and Allocation

ASC 842 currently allows lessees a practical expedient to not separate the non-lease components, and instead, consolidate the entire contractual agreement as a lease. The proposed practical expedient would alleviate many of the complexities related to separating components and appropriately allocating consideration.

It is expected the practical expedient to be most frequently adopted when the non-lease components of a contract are insignificant or immaterial when compared to the lease components of an agreement. The practical expedient is not intended for and does not allow lessees to account for multiple lease components of a contract. Lessees who accept the policy election to account for a contractual lease component and its associated non-lease components as "one" lease component allocate all contract consideration to the lease component or right-of-use asset. The consequential impact is that the measurement of the lease liability and right-of-use asset is greater than if the policy election was not applied and will have a noted effect on a lessee's impairment analysis.

Recommendations Moving Forward

The key right now is readying yourself for the transition and "discovering" the anticipated impact to your company and the related financials. Through this process, a complete population of leases by type and location should be documented. The complexity of lease agreements should be evaluated to determine the level of effort required to extract the needed data for both financial statement reporting and related disclosures. The impact on debt covenants should be calculated and evaluated to serve as conversation and negotiation points with lenders. And assess what changes, if any will be required by IT systems to capture and report needed data related to lease agreements.

By completing this discovery process, companies should fully document the steps taken as well as the information obtained to capture the thought process in evaluating the change in accounting. Furthermore, companies should proactively engage their banking partners to re-evaluate the impacted covenants to negotiate updates or the addition of language to the debt agreement noting "covenant calculations will not change based on accounting standard changes driven by governing bodies," or similar language to protect the company from future accounting standard adjustments. Proactive communication will help reduce frustrations caused by unintended debt covenant violations.

Kevin Stewart is Audit Senior Manager with Briggs & Veselka and works with public and private companies within manufacturing, consumer products, and oilfield services financial reporting and internal control matters. He has spent half his career in public accounting and half in industry, primarily in retail, where leases are a significant portion of operating costs.

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