Mastering the Lease Accounting Changes

FASB
Topic 842

Banking Industry Focus

iLeasePro

Taking the FASB Lease Accounting Standard Changes from Strategy to Execution

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Introduction

This whitepaper presents the most important elements of the Financial Accounting Standards Board ("FASB") lease accounting standard changes ("ASC 842") at a high level to provide the reader with a basic understanding of the changes and the potential impact to banks as both a lender and a lessee.

The FASB has published new lease accounting standards designed to provide greater balance sheet transparency of leasing activities for organizations that issue financial statements in accordance with generally accepted accounting principles ("GAAP").

Leases, currently classified as operating leases, allow the lessee to avoid recognizing both the lease obligation as a liability and expensive investments as fixed assets on its financial statements. The standard changes require that all leases, except certain narrowly defined short-term leases, be recognized on lessee balance sheets as a Lease Liability with an offsetting Right to Use asset.

The definition of a lease is more complicated and many provisions in the lease will require expert evaluation to determine whether there are accounting implications that must be addressed.

With respect to expense recognition, the FASB requires the classification of leases into two types (finance and operating) with many equipment leases falling into finance and most real estate leases falling into operating. However, for many leases, judgment will have to be applied to ensure that the lease classification is appropriate. For a finance lease, expense recognition would be accelerated while for an operating lease, expense would be recognized basically on a straight-line basis as is the case under current GAAP.

Lease accounting will be more complicated for lessees. And remember, the new lease accounting standard applies to all leases that fall under the definition of a lease in the ASC 842, both real estate and equipment leases.

Basic Provisions of FASB Topic 842

The provisions of ASC 842 require that the financial statement preparer determine these most important elements associated with a lease (not meant to be all inclusive):

- Does the contract in question meet the definition of a lease for accounting purposes?
- Does the contract contain any non-lease components?
- What is the lease term?
- What are the lease payments?
- How should a lease be classified?

A lease is … a contract that conveys the right to use an asset …

A lease is defined as a "contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration". Therefore, the lessee must be able to identify an asset or assets that can be used and also demonstrate that the contract allows the lessee to control the use of the identified asset for some period of time in exchange for consideration. In most cases, this will be a rather straightforward evaluation but there are situations involving, for example, where the lessee or the lessor have the right of substitution of an asset or where it is not clear which party has control of the asset that will require judgment to determine whether the definition of a lease is met. For example, a bank may execute an agreement with a vendor to have the vendor supply IT equipment for use in banking operations. But the vendor may have complete discretion over what type of equipment to provide and may be able to substitute equipment. It is highly questionable whether this type of agreement would qualify as a lease according to ASC 842.

… evaluate whether any non-lease components are contained in the contract …

ASC 842 requires that the lessee evaluate whether any non-lease components are contained in the contract and whether such non-lease components should be accounted for separately. An example of this situation is where a manufacturer lessor of equipment requires that the contract with the lessee include maintenance services of the equipment that are provided by the lessor.

… the FASB has retained the requirement that most lease contracts be recorded on the balance sheet of the lessee …

Determining the lease term and the lease payments associated with the lease term are significant because the FASB has retained the requirement that most lease contracts be recorded on the balance sheet of the lessee using a right-of-use model for recording the right-of-use asset ("the ROU asset") and the liability to make lease payments. Under current GAAP accounting for operating leases, the leased asset and the liability for lease payments are not recorded on the balance sheet. Individual lease payments are accrued each month as they become due and payable. The ASC 842 calculation of the lease liability is derived from the present value of the fixed lease payments beginning with the lease commencement date (the date at which the lessor makes the underlying asset available to the lessee) with the possible inclusion of certain lease incentives, certain renewal option periods, residual value guarantees expected to be paid and certain purchase and lease termination options. The initial carrying value of the ROU asset would be equal to the initial value of the lease liability plus any initial direct costs associated with negotiating and arranging the particular lease (such as attorney's fees), any payments made to the lessor at or before the commencement date of the lease less any lease incentives received from the lessor. The discount rate to be utilized in the present value calculation would be determined on a lease by lease basis and would be the rate used by the lessor for the particular transaction. Since the lessee may not know the rate used by the lessor, as an alternative, the lessee could use its own incremental borrowing rate at the lease commencement date.

The FASB has included changes to reduce the complexity of ASC 842 including:

- The lessee can make an accounting policy election to apply the current GAAP operating lease accounting model for those short-term leases that have a maximum possible lease term of 12 months or less, including option periods.
- The previous requirement to include variable lease payments has been revised to apply only to those payments that are based on an index or a rate or that are in-substance fixed

payments.

- The requirement to include payments during an option period has been redefined to include only those payments where the lessee has a significant economic incentive to exercise the option.
- Lease and non-lease components (predominantly services provided by the lessor) are accounted for separately, however, the FASB has provided a practical expedient to lessees whereby they can combine lease and non-lease components into one lease component.

… lease classification is based upon the nature of the asset being leased and how lease related expenses are recognized.

Lease classification is based upon the nature of the asset being leased and how lease related expenses are recognized. Leases of assets that are not property (mainly equipment) are classified as finance leases unless either the lease term is for an insignificant portion of the leased asset's economic life or the present value of the lease payments is insignificant versus the asset's fair value. Leases of property are classified as operating leases unless either the lease term is for the major portion of the leased asset's remaining life or the present value of the lease payments accounts for substantially all of the asset's fair value. Recognition of lease related expense differs significantly depending upon how the lease was classified. For a finance lease, the lease liability is accreted using the interest method with lease payments being used to reduce the liability. The ROU asset is amortized on a straight-line basis. This "interest method' pattern results in overall accelerated expense pattern in earlier periods and lower expense in the later periods of the lease term. Additionally, interest and amortization expense is presented separately in the financial statements for a Finance lease.

For an operating lease, the lease liability is accreted in the same manner as a Finance lease but the amortization of the ROU asset is adjusted so that the overall lease expense is recognized essentially on a straight-line basis. For operating leases, a single lease expense line item is presented in the financial statements, comprising both the interest and amortization components.

The ASC 842 expense classification presents an interesting point with respect to an important financial statement metric, Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Interest and amortization on finance leases would be added back in the calculation of EBITDA while lease expense on operating leases would not be. Therefore, while overall expense would increase in earlier years of the lease term for those entities that have a greater proportion of finance leases, EBITDA would also be higher by virtue of the add back of interest and amortization. The statement of cash flows would also be impacted. For operating leases, the lease expense would be a reduction in operating cash flow as is the case under current GAAP accounting for operating leases. For finance leases, cash payments for the principal portion of the lease payment would be classified as a financing activity. The result – operating cash flow would be higher for finance leases.

Reassessment

After the date of commencement, the lessee may have to reassess the initial accounting for the lease transaction if either the lease term or the lease payment stream changes.

Circumstances that could trigger reassessment include:

- The index or rate utilized to measure the variable lease payments changes, for example, where CPI increases are included in the lease terms and the CPI index initially utilized changes or
- The lease contains option periods and the lessee original conclusion as the whether there is a significant economic incentive to exercise the option changes, like the option to renew.

The reassessment may be required at each reporting period and result in the adjustment of the carrying amounts of the lease liability and the ROU asset. Additionally, if the reassessment does result in a change in the lease payment stream, the rate utilized to discount the payments may also have to be reassessed.

Disclosures

ASC 842 requires a series of both qualitative and quantitative disclosures in order for the financial statement reader to understand more completely the nature of the lessee's lease portfolio. Unless separately disclosed in the financial statements, the lessee is required to disclose all financial statement amounts relating to the lease portfolio in the footnotes. Qualitative disclosures would include, among other matters, significant judgments made in applying the accounting guidance, information about the nature of the lease portfolio, including a description of the types of leases and certain information regarding options and variable lease payments. Quantitative disclosures include a reconciliation of opening and closing balances of the aggregate lease liability separately for finance and operating leases (this disclosure would be optional for nonpublic companies) and a maturity analysis of the lease liability reflecting the undiscounted cash flows which would include a reconciliation to the ending carrying value of the lease liability.

Transition

ASC 842 provides for a modified retrospective transition with no grandfathering of existing leases at the time of adoption. The lessee can either restate all prior periods and apply transition to the beginning of the earliest period presented in the financial statements or apply transition at the date of adoption and choose not to restate prior periods.

Effective Date

The effective date for public business entities is the first reporting period beginning after December 15, 2018, including interim financial statements. Other entities have until annual periods beginning after December 15, 2019. But those dates represent the end of the process, not the beginning. Any existing lease in place on the adoption date will have to be identified, measured and presented on the balance sheet, reflecting the new rules.

Banking Industry Considerations

With respect to the ASC 842 changes to lease accounting, the Banking Industry is somewhat unique in that these ASC 842 changes will impact banks in customer relationships with the bank as a lender and will also impact the industry operationally with the bank as a lessee.

The Bank as a Lender

The impact of the ASC 842 changes on borrowers' financial statements could be significant, depending upon the extent of leasing being done and the type of assets being leased by the borrower. Liabilities will certainly increase, expense recognition will probably be accelerated, and expense classifications will probably change, along with cash flow classifications. Bank lending departments may have already tried to adjust for existing operating lease "liabilities" in their internal evaluation of borrowers' financial statements but outreach performed by the FASB has indicated that these adjustments made by analysts have contained assumptions that are highly inaccurate. Among other things, Bank lending departments should consider the following action items:

- Relationship managers should begin immediately to discuss with borrowers the effect that the ASC 842 changes will have on the borrowers' financial statements.
- Financial covenants, which are one of the more important sections of the loan agreement, will likely be impacted by the changes to the borrowers' financial statements. Debt to equity, EBITDA and other ratios will change and may cause

non-compliance with financial covenants. Lending departments should anticipate these effects and have a plan in place to address these compliance issues.

- Changes to borrowers' financial statements will affect how the risk of the loan relationship is rated in the bank credit assessment process. Risk managers should anticipate this issue and have a plan in place to address the implications.

The Bank as a Lessee

Banks that have current lease arrangements at the implementation date will be required to recognize the liability for these leases on their balance sheet.

Due to this change banks may experience the following:

- Need to increase regulatory capital amounts
- Impact to capital and leverage ratios
- Changes in leasing strategies
- Future tax implications

Example Bank Lessee Scenario

An example may the best way to demonstrate how a Bank may be impacted as a lessee of both real estate and equipment and the effect on Bank financial statements of the provisions in ASC 842.

The Bank lessee in our example has three leases,

(1) An ATM location

(2) A branch location

(3) A lease for IT equipment

The lease for the ATM location is for a term of 12 months and does not contain any renewal options. The lease for the branch location is triple net for a term of seven years and there aren't any non-lease components (such as real estate related costs) that have to be considered separately. The lease for the IT equipment is for a term of five years and maintenance costs are borne separately by the lessee. With respect to the branch location and the IT equipment leases, there are no options to extend, variable lease payments, purchase options or residual value guarantees contained in the lease agreements and no initial direct costs that have been incurred in executing the leases.

The lease for the ATM location provides for a rent payment of $1,000 per month and the Bank has determined that the lease meets the criteria for a short-term lease as provided in ASC 842 since the lease term is for a maximum period of 12 months or less. Therefore, the Bank will take advantage of the accounting policy election that allows the Bank to treat this lease essentially the same as an operating lease under current GAAP and amortize the rental stream to expense evenly over the 12-month lease period with no requirement for balance sheet recognition of the liability. The lease for the branch location provides for rent of $15,000 per month and the Bank has determined that this lease is an Operating lease since it is a property lease, the lease term (seven years) is not for a major part of the remaining economic life of the real estate and the present value of the lease payments are insignificant when compared to the fair value of the underlying asset. The lease for the IT equipment provides for rent of $10,000 per month and the Bank has determined that this lease is a Finance lease since the underlying asset is equipment and the lease term (five years) is for a significant part of the total economic life of the underlying asset. For both the branch location and the IT equipment leases, the present value of both payment streams must be calculated and, since the Bank is not privy to the interest rate that was utilized by the lessor in structuring the leases, the Bank will use its incremental borrowing rate for the present value calculation – assumed to be 5%.

The financial results under ASC 842 GAAP are as follows:

Balance Sheet

	ASC 842 GAAP	
	Lease Liability	ROU Asset
Year 0	$1,591,185	$1,591,185
Year 1	$1,355,317	$1,365,621
Year 2	$1,112,805	$1,128,518
Year 3	$863,307	$879,283
Year 4	$606,467	$617,298
Year 5	$341,908	$341,908
Year 6	$175,218	$175,218
Year 7	$-	$-

Income Statement

ASC 842 GAAP				
	Lease Expense	Interest Expense	Amortization Expense	Total
Year 1	$192,000	$24,322	$105,981	$322,303
Year 2	$180,000	$19,427	$105,981	$305,408
Year 3	$180,000	$14,282	$105,981	$300,263
Year 4	$180,000	$8,873	$105,981	$294,854
Year 5	$180,000	$3,188	$105,981	$289,169
Year 6	$180,000	$-	$-	$180,000
Year 7	$180,000	$-	$-	$180,000

… under the ASC 842 GAAP as it relates to the balance sheet, the Bank would have both a significant liability and asset that must be recognized on its balance sheet …

Note that under the ASC 842 GAAP as it relates to the balance sheet, the Bank has both a significant liability and asset that must be recognized on its balance sheet. Both the liability and the asset balances decline as payments are made and amortizations are charged to income and are equal to zero at the end of the seventh year (the final year of the branch location lease). The ROU asset that must be recognized is not a tangible, interest-earning asset and will not enhance financial viability while the lease liability will be included in the overall indebtedness of the Bank. Since the Bank's equity would not change, the total asset to total equity and the total debt to total equity ratios would change significantly and the impact is particularly negative as to the total debt to total equity ratio. Most critically, the Bank capital ratio will decline at a time when most banks are striving to increase capital ratios and bank regulators are particularly focused on the capital adequacy issues.

The Bank lessee's income statement becomes considerably more complicated. The expense recognition for the finance

… the Bank capital ratio will decline at a time when most banks are striving to increase capital ratios …

equipment leases is accelerated into the early years of the lease term and the finance lease expense is now presented in two separate categories of interest and amortization expense. The expense presentation for the operating branch property lease and any lease that qualifies as a short-term lease remains consistent with Current GAAP, namely, straight-line recognition. The total column is presented here for illustrative purposes only to show how total expense will be impacted under ASC 842 GAAP but that amount will not be presented separately in the financial statements.

The three-lease example that we have presented is relatively straightforward but it is important to focus on the fact that, even with this somewhat simplified example, the increased debt that must be recognized on the balance sheet amounts to more than $1.5 million. Think about all the leases that the typical bank might have for ATMs, branches and various types of equipment and one can easily see that the overall effect on the financial statements can be extremely significant. Additionally, the ASC 842 changes to the lease accounting standard present a number of management and accounting challenges for banks (and all lessees) as follows:

- What leases qualify as short-term leases?
- Will the bank adopt the accounting policy election to account for short-term leases on essentially a straight-line expense basis and track those leases separately?
- Since the liability for short-term leases does not have to

be recognized on the balance sheet, will management attempt to structure additional leases that will qualify for short-term treatment?

- The liability for all other leases, whether for property or equipment, must be recognized on the balance sheet. Should management strive to shorten the term of future leases in order to decrease the amount of additional liabilities that will have to be recognized?
- Is it better to buy versus lease since the balance sheet "benefit" of leasing will be eliminated under the ASC 842 standard?

Introducing the concept of two different types of leases depending upon the nature of the underlying asset may be relatively straight forward in most cases but, in some cases, this distinction may cause additional complexity and subjectivity, particularly with respect to the lease term as compared to the economic life and fair value of the leased asset.

The different expense treatment of finance and operating leases may cause additional confusion in financial statement analysis as compared to current operating lease accounting. For many banks, control and decisions regarding leasing are performed at the operating department level with little overall coordination by the finance function. Due to the significant financial impact of the ASC 842 accounting, the finance function will have to be much more involved in monitoring the leasing decisions made at the operational level.

With respect to the financial implications and operational strategies related to the ASC 842 lease accounting changes, the CFO of a major international bank commented and acknowledged that the bank may well have to increase regulatory capital in order to offset the effect of the increase in leased assets and liabilities, particularly related to branch locations. As to the issue of buy versus lease, the executive made the point that the strategy for branch locations may continue to focus on leasing since many of the prime locations are only available through leases.

Next Steps

Timely preparation is the key to an effective implementation. Summarized below is just a partial list of next steps that banks should be considering in preparation for the lease accounting changes.

Increase Internal Communication

Make sure that bank lending department management is aware of the ASC 842 accounting change so that the impact to lending relationships and financial covenants of lending agreements can be assessed, along with loan risk rating procedures.

Evaluate Current Procedures and Systems

The issues that must be considered are more numerous and complex than under the current accounting standards and require a complete understanding of all of the terms of the lease. In addition, the reassessment requirements are much more are rigorous. Remember that existing leases at the time of adoption will not be grandfathered. It is critical that the terms of each lease be documented clearly and consistently in a manner that allows for ready review. Bank lessees should strongly consider the need for a technology solution that captures all of the key provisions of the lease and stores them in an easily accessible format.

Review Current Leasing Strategy

How will your leasing strategy change as a result of the new accounting standards? No one wants accounting implications to drive the economics of the organization but they will undoubtedly be a consideration. Will lease versus buy decisions change? Will lease terms change? Longer lease terms will result in larger liability balances, however, shortening lease terms, particularly for branch leases, may not be in the best operational interests of the bank.

Understand Changes to Financial Reporting

Financial statement analytics will change dramatically. Banks should consider the implications on among other things, debt covenant compliance, employee compensation plans, contractual agreements and other key legal documents. Determining the impact of the ASC 842 changes on overall capital levels and capital ratios will be extremely important for productive discussions with bank regulators and analysts.

Review Potential of Tax Implications

Income tax policy is unlikely to change as a result of the ASC 842 accounting changes; therefore, book-tax differences will likely increase and result in a more complex tax computation.

Begin Data Gathering

Research has indicated that one of the most challenging tasks of this implementation will be the gathering and data entry of the key data required.

About the Author

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About iLeasePro

iLeasePro offers an **uncomplicated approach to lease accounting** for Lessees & Tenants of real estate and equipment leases. iLeasePro is a cost effective, cloud-based Lease Accounting and Lease Management technology solution that raises transparency, supports information sharing capabilities and efficiency to the lease portfolio of Lessees. iLeasePro offers mid-market companies the ability to comply with the FASB (ASC 842) Lease Accounting Standard changes.