

Conversation with the FASB

What You Need to Know About the Lease Accounting Exposure Draft



Housekeeping

- If you are experiencing technical difficulties, please dial: **800-263-6317.**
- **Q&A session will be held at the end of the presentation.**
 - Your questions can be submitted via the **Questions Function at any time during the presentation.**
- The **PowerPoint presentation**, as well as the **webinar recording**, will be sent to you within the next 10 business days.
- Please complete our online survey.

CPE Requirements

- Answer the polling questions
- If you are participating in a group, complete the CPE sign-in sheet and return within two business days
 - Contact sada.kempf@CLAconnect.com
- Allow four weeks for receipt of your certificate; it will be sent to you via email

About CliftonLarsonAllen

- A national CPA and consulting firm
- Service areas include assurance, tax, consulting, and outsourcing
- 3,600 people with industry specific perspectives
- Offices coast to coast



Speaker Introductions

- **Marc Siegel, FASB Board Member**

- Appointed to the Financial Accounting Standards Board (FASB) in 2008, reappointed to second five-year term in 2013
- Brings an investor perspective to the Board
- Recognized professional in forensic accounting with more than 20 years of experience in diverse and global industries

- **Jim Davidson, Partner, CliftonLarsonAllen**

- Partner in CLA's Construction and Real Estate group
- Nearly 25 years of extensive audit and accounting, tax, and consulting experience
- Works closely with privately held businesses on lease accounting and other consulting topics such as operational issues, owner and management transitions, acquisition or sale of businesses, as well as traditional tax and estate planning

Learning Objectives

- At the end of this session, you will learn:
 - Why the FASB is revamping the current lease accounting standards
 - Proposed changes to the lease accounting exposure draft
 - Implications for businesses, investors, and creditors
 - Implementation timeline and next steps



Polling Question

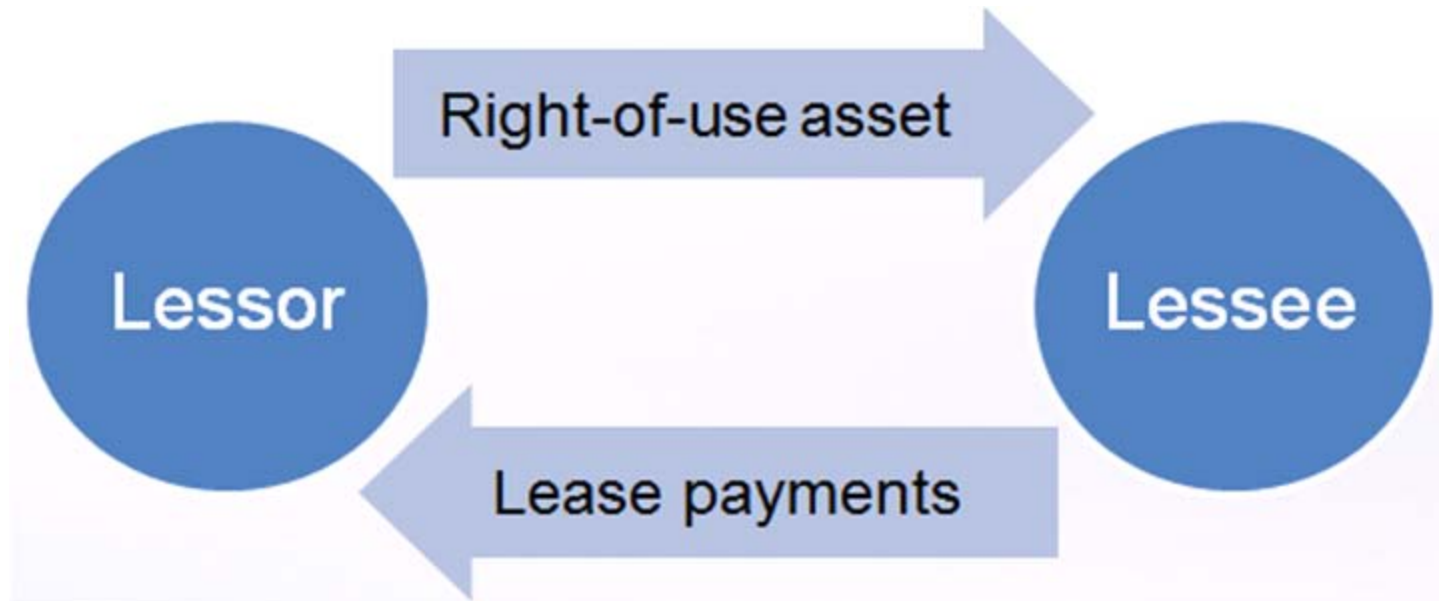
Why a Leases Project?

- Lessee
 - Most lease assets and liabilities are off-balance sheet
 - Limited information about operating issues
- Lessor
 - Lack of transparency about residual values
 - Consistency with lessee proposal and revenue recognition proposal

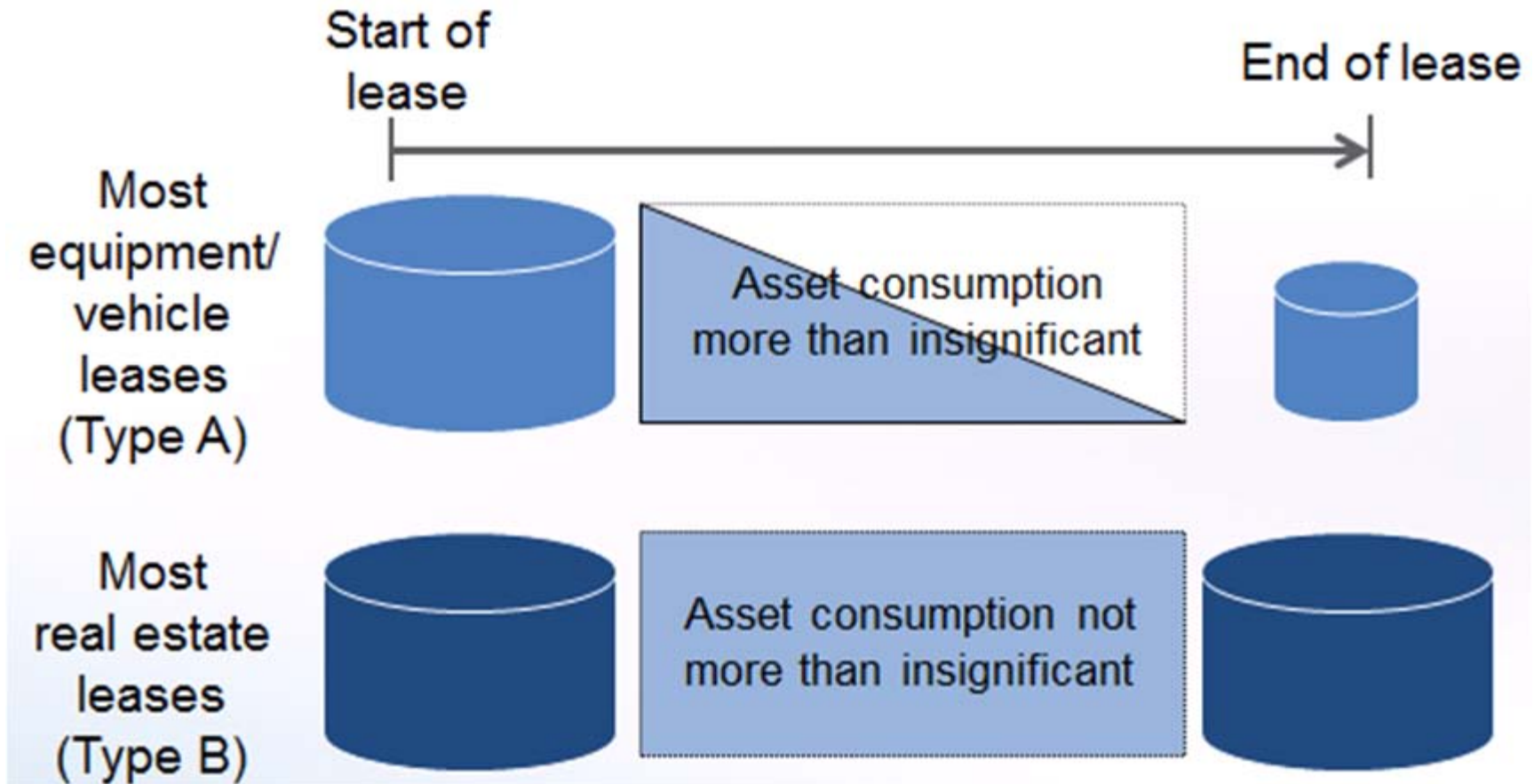
\$1.25
trillion
of off-balance sheet
operating lease
commitments for SEC
registrants*

* Estimate according to the 2005 SEC report on off-balance sheet activities

Proposed Right-of-Use Model



Dual Approach



Lease Classification Test

Leases of equipment/vehicles are Type A unless

- Lease term is insignificant relative to total economic life of asset, or
- Present value of lease payments is insignificant relative to fair value of asset

Leases of real estate are Type B unless

- Lease term is major part of remaining economic life of asset, or
- Present value of lease payments is substantially all of fair value of asset



Polling Question

Why a Leases Project – practitioner observations

- Equipment leases
 - “Off Balance Sheet Financing” industry – self contradictory
 - Usually easy to craft a lease as operating. Many leases have PV of minimum lease payments at 89% of cost of equipment!
 - Equipment intensive industries: balance sheet comparability problem

Why a Leases Project – practitioner observations

- Real Estate Leases
 - Current standards are confusing, hard to explain to clients
 - Inconsistent application, e.g. leases with SBA loans
 - Beyond confusing – sometimes irrational, e.g. being forced to record a capital lease, then cannot get out of it when the lease changes!

Why a Leases Project – practitioner observations

- Some users argue that balance sheets should not contain lease assets and liabilities, because they are “artificial”
- Experiences supporting the Leases Project (good accounting = few unnecessary surprises):
 - Companies trying to shrink often have unexpected losses arising from leased equipment
 - Real estate leases are often a highly contentious issue in workout situations

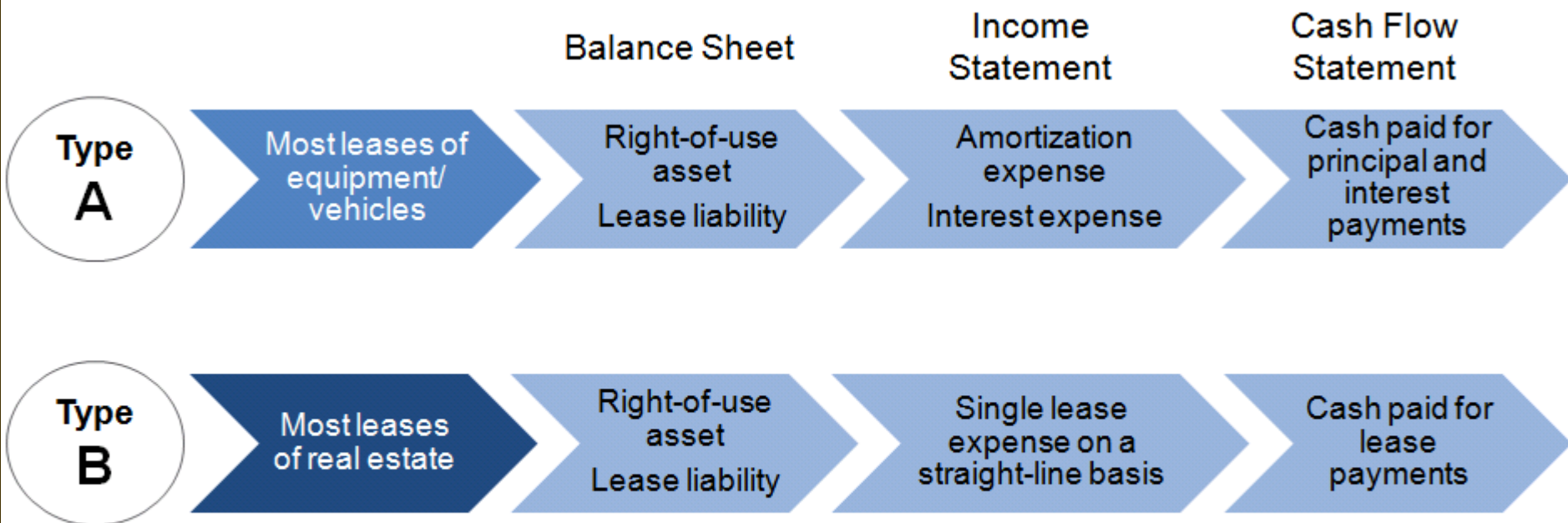
Dual Approach - Comment

- Big improvement towards consistency with underlying understanding of the nature of leases
- 5 year equipment lease really does look very much like a purchase of the equipment in a practical sense. Very similar terms
- 10 or even 20 year building lease is not nearly as close to a purchase



Polling Question

Lessee Accounting Overview



Lessee Disclosures

Qualitative

Description of leases

Terms of:

- variable lease payments
- extension/termination options
- residual value guarantees

Restrictions and covenants

Information about leases not yet commenced

Quantitative

Maturity analysis of undiscounted cash flows for each of first 5 years plus total thereafter

Reconciliation of lease liability¹

Expense relating to variable lease payments

Reconciliation of right-of-use asset by asset class (IASB only)

Judgments & Risks

Nature and extent of risks arising from leases

Significant assumptions and judgments

¹FASB only: Nonpublic entity may elect not to disclose

Lessor Accounting Overview

Balance Sheet Income Statement Cash Flow Statement

Type A

Most leases of equipment/vehicles

Lease receivable
Residual asset

Interest income and any profit on the lease

Cash received for lease payments

Type B

Most leases of real estate

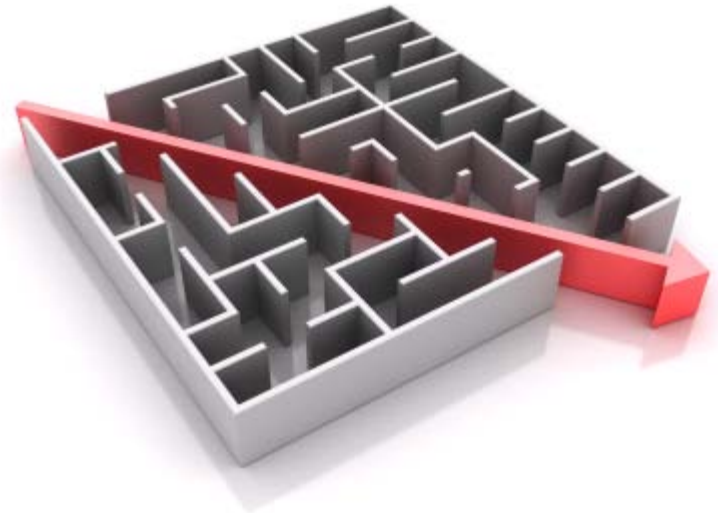
Continue to recognize underlying asset

Lease income, typically on a straight-line basis

Cash received for lease payments

Reducing Cost and Complexity in Response to Feedback on the 2010 ED

- Short-term leases
 - Option to exclude leases with a maximum term of 12 months or less
- Variable lease payments
 - Excluded if payments are not linked to an index or a rate
- Renewal options
 - Excluded unless significant economic incentive to exercise the option



Nonpublic Entity Reliefs and Related Party Leases

- FASB decided to provide two reliefs for nonpublic entities
 - Accounting policy election to discount lease liabilities using a risk-free rate with a term comparable to that of the lease term
 - Election must be disclosed
- Related party leases – recognition and measurement requirements should be applied based on legally enforceable terms and conditions
 - Entities must disclose terms and conditions of related party leases

Lessee Accounting Overview– Practical observations

- Equipment/Type A lease accounting closely tracks with a purchase of the same equipment
- What is a borderline operating lease under existing standards will be on the books
- For real estate, what is an operating lease under existing standards will now be on the books: assets and liabilities both increase
- For real estate, expense is straight-line, similar to current standards

Lease Accounting Overview – Problems in Practice

- Income statement and balance sheet will change
 - Higher debt means higher debt to equity ratios
 - Lower working capital due to current portion of liability
 - For Type A leases, higher EBIT or EBITDA, but more debt on the books

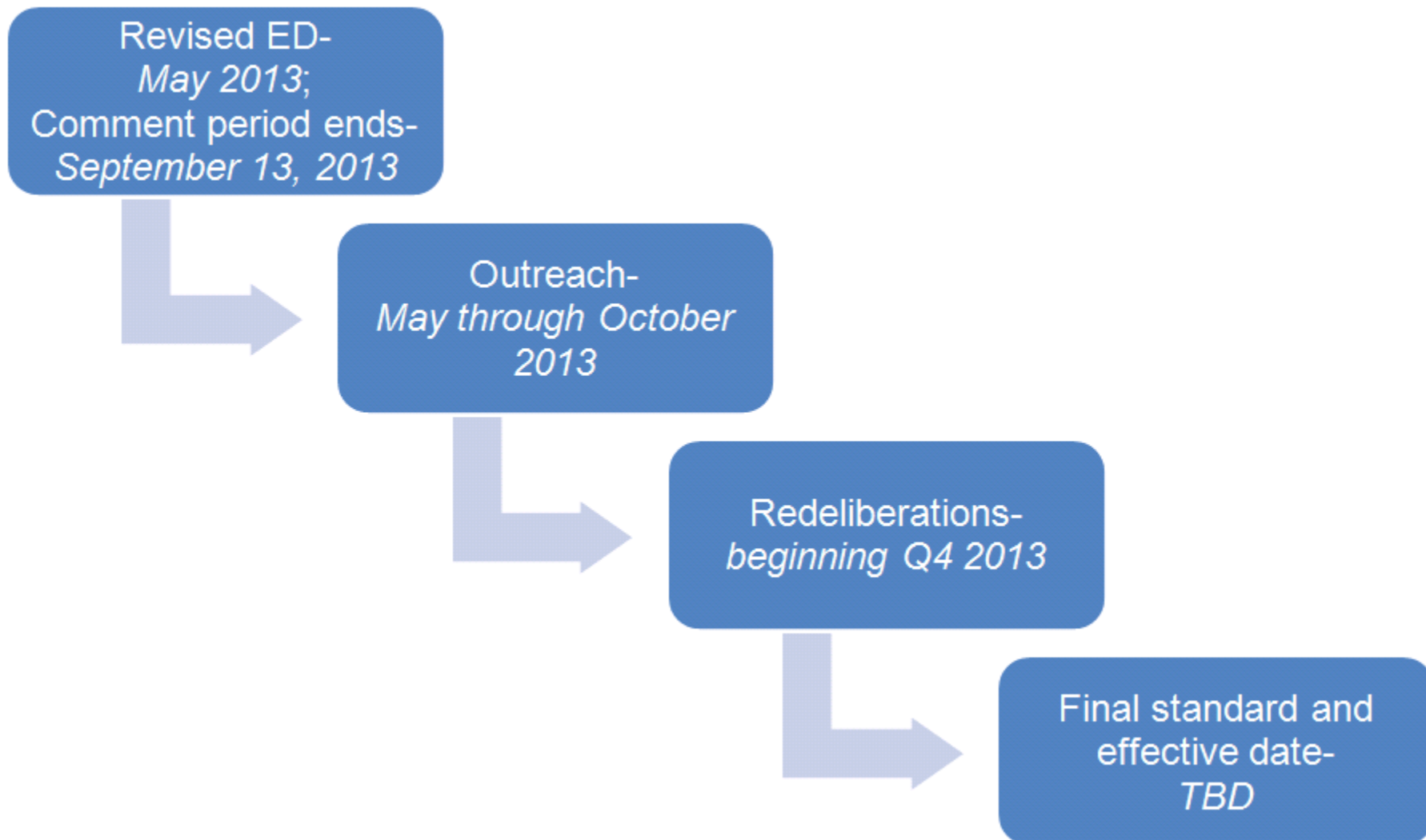
Lease Accounting Overview – Problems in Practice

- Information gathering for multi-location companies
- Still some discretion in dealing with renewal options, contingent payments, varying interest rates
- Related party leases are recorded based on legally enforceable terms, but still have problems with short lease but large Leasehold Improvements



Polling Question

Next Steps



Private Company Council (PCC) Proposal: Applying VIE Guidance to Common Control Leasing Arrangements

- Current GAAP requires a company to consolidate a VIE when it is considered the primary beneficiary of the VIE
 - VIE guidance could require a lessee to consolidate a VIE lessor entity when they are under common control and lessor entity's primary activity is leasing
- Under the proposal, private companies could elect to not apply VIE guidance for assessing whether they should consolidate lessor entities when arrangement meets following conditions:
 - Private company and legal entity are under common control
 - Private company has lease arrangement with legal entity
 - Substantially all activity between two entities is related to leasing activity of legal entity

PCC Proposal: Applying VIE Guidance to Common Control Leasing Arrangements

- Additional disclosures would be required, including:
 - Key terms of leasing arrangement with lessor under common control
 - Amount of debt/significant liabilities of lessor
 - Key debt agreements at lessor
 - Any other explicit interests in lessor
- Does not apply to publicly traded companies and nonprofit organizations
- Accounting alternative would be retrospectively applied to all leasing arrangements that meet requirements
- Alternative reduces cost and complexity associated with applying VIE guidance to leasing arrangements under common control



Questions?

Thank you

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