LEASE ACCOUNTING (TOPIC 842):

A Guide for Tech Companies

CONTENTS

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Lease Accounting Overview

In February 2016, the Financial Accounting Standards Board (FASB) issued its highly-anticipated leasing standard in ASU 2016-02, *Leases (Topic 842)*, for both lessees and lessors. Under its core principle, a lessee will recognize right-of-use ("ROU") assets and related lease liabilities on the balance sheet for all leases, except for short-term leases (12 months or less) for which the recognition exemption is elected. The most significant change will be on the balance sheet for lessees. The pattern of expense recognition in the income statement will depend on a lease's classification and will be consistent with current U.S. GAAP (Generally accepted accounting principles).

Today, there are two types of accounting methods for lessees, depending on the type of lease: capital leases and operating leases.

- **Capital Lease:** A capital lease is recorded on the balance sheet because the lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee.
- **Operating Lease:** An operating lease, on the other hand, stays off the balance sheet. Payments by the lessee to the lessor are considered operational expenses. Operating leases are often disclosed only in financial statements. A vast majority of leases today, such as building leases, are operating leases.

Tomorrow, the above two lease classifications for lessees will still exist, although capital leases now will be called finance leases. The following table summarizes the lessee accounting for finance and operating leases under the new standard:

Financial Statement	Finance Lease	Operating Lease
Balance Sheet	Recognize ROU asset and lease liability at the commencement date of the lease. The lease liability, initially and subsequently, is measured at the present value of the unpaid lease payments. The ROU asset initially is measured at the amount of the lease liability initially recognized, plus initial direct costs and prepaid lease payments, less lease incentives received. The ROU asset is subsequently amortized generally on a straight-line basis.	Recognize ROU asset and lease liability at the commencement date of the lease. The initial and subsequent measurement of the lease liability, and the initial measurement of the ROU asset, are the same as for finance leases. The ROU asset is subsequently amortized in such a way so that the lease cost is recognized on a straight-line basis over the lease term in the income statement (which results in an increase in the periodic amortization of the ROU asset over the lease term).
Income Statement	Recognize interest on the lease liability separately from amortization of the ROU asset.	Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis.
Cash Flows	Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities.	Classify all cash payments for leases within operating activities.

The FASB also provided lessees only (i.e., not lessors) with a recognition exemption for short-term leases. The short-term lease exemption applies to leases with terms of 12 months or less and which do not include an option to purchase the underlying asset that is reasonably certain to be exercised. This election is made by asset class. If elected, leases that qualify for the exemption are not recognized on the balance sheet, and the lease payments related to those leases are recognized generally on a straight-line basis over the lease term in the income statement, essentially resulting in an accounting outcome that is consistent with the legacy leases guidance in Topic 840, *Leases*.

However, this exemption does not mean that short-term leases are scoped out of the new requirements. For a lease to qualify as a short-term lease, lessees will need to assess the lease term as for any other lease (e.g., determine whether it is reasonably certain the lessee will exercise a renewal option), and short-term leases will be subject to the reassessment requirements of the new standard. Short-term leases will also be subject to other requirements in the new standard, including disclosures. Accordingly, lessees will need to have appropriate processes and controls under the new standard, even for short-term leases.

For lessors, the accounting remains relatively consistent with previous U.S. GAAP. Leases will continue to be classified as sales-type, direct financing, or operating, and the accounting under those lease classifications will be substantially similar to current GAAP. The one exception is that the new standard no longer allows leveraged lease treatment for leases that are entered into, or modified, after the effective date of the standard. As a result, new or modified leases that would have met or previously met the definition of a leveraged lease will be accounted for as one of the other three types of leases. Existing leveraged leases, however, are grandfathered into the standard and should continue to be accounted for by the lessor under prior guidance until they expire or are modified.

The lessor accounting has also been updated for consistency with the lessee accounting model and with the new revenue standard, ASU 2014-09, which will result in some important changes to certain aspects of lessor accounting (e.g. the separation and allocation guidance, the impact collectability uncertainties and significant variable lease payments have on lease classification, what costs qualify as initial direct costs, and the accounting for sale and leaseback transactions).

This publication summarizes the new leasing guidance and how certain aspects may impact tech entities.

DEADLINES

The new standard takes effect for public entities and certain other entities for fiscal years, and interim periods within those fiscal years, beginning after **Dec. 15, 2018**. For a calendar year-end public entity, the effective date is **Jan. 1, 2019**.

For most other entities, the new standard will take effect for fiscal years beginning after **Dec. 15, 2019**, and for interim periods within fiscal years beginning after **Dec. 15, 2020**.

Early application is permitted for all entities.

ASU 2016-02 initially provided a single transition method with which to adopt the new leases guidance: the modified retrospective transition method. Under that transition method, entities apply Topic 842 retrospectively to each prior reporting period presented, subject to specific practical expedients and transition requirements (such as the use of *minimum rental payments,* as applied under the legacy leases guidance for recognizing existing operating leases on the balance sheet). Under this transition method, in addition to updating their lease accounting methods, entities must present prior periods on their financial statements in accordance with Topic 842, including recognizing operating leases on the prior period balance sheet for lessees (even if leases have expired before the effective date) and providing new and enhanced disclosures in all periods presented, including the prior periods. This can be an arduous and time-consuming task, making it imperative that entities begin the process now.

However, on July 30, 2018, the FASB issued ASU 2018-11, *Leases (Topic 842) – Targeted Improvements*, which provides entities with an additional (and optional) transition method with which to adopt the new lease guidance. Under this new transition method, entities initially apply the new guidance at the adoption date (rather than at the beginning of the earliest period presented) and recognize a cumulative effect adjustment to the opening balance of retained earnings in the period of adoption (for example, Jan. 1, 2019 for a calendar year-end public entity). This means that the comparative periods presented in the financial statements will remain under the legacy leases guidance. The FASB provided this additional transition method to reduce costs and complexity for preparers in implementing the new standard. However, even with this welcomed relief, entities should not delay their implementation efforts considering the numerous implementation activities that must take place for a successful and timely adoption.

BACKGROUND

The FASB leases project began as one of several joint projects with the International Accounting Standards Board (IASB) aimed at converging U.S. GAAP and International Financial Reporting Standards (IFRS). However, while some aspects of the final standards (IFRS 16, *Leases* and ASU 2016-02) are converged (such as the definition of a lease), the two standards are not fully converged and there are numerous important differences to keep in mind. This publication focuses solely on ASU 2016-02 and does not address the accounting differences between the two standards.

The objective of updating the leases guidance was to increase transparency and comparability among entities by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.

The new guidance is intended to address stakeholder concerns that the previous leases guidance did not result in a faithful representation of leasing transactions—specifically that the rights and obligations associated with operating leases were not recognized on the balance sheet.

SCOPE

The scope of the new standard is generally consistent with prior guidance and limits the application of the standard to leases of property, plant, or equipment. The glossary defines a lease as "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration."

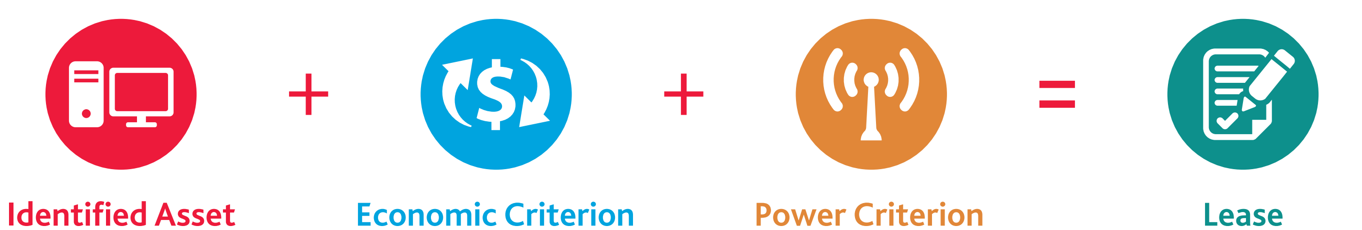
Under prior GAAP, the key determination was whether a lease was an operating or capital lease, as that drove whether a lease was recognized on the balance sheet. There were no major differences in accounting between an operating lease and an executory contract, and because most leases were classified as operating leases, entities may not have historically put significant focus on the prior lease definition. Under the new standard, however, the key determination will be on whether a contract is, or contains, a lease, as that will drive whether a contract is recognized on the balance sheet. Accordingly, entities can expect to devote significant time on this aspect of the guidance to ensure they comply with the new requirements.

The new standard will impact all entities with contracts for the use of assets, such as equipment (i.e. computers, transportation vehicles, airplanes, etc.) and real estate (i.e. office buildings, warehouses, factories, manufacturing plants, etc.), and that meet the definition of a lease, even when the lease is embedded in a contract that includes other goods or services.

The new standard applies to all leases except:

- Leases of intangible assets (Topic 350)
- Leases for exploration or use of certain natural resources (Topics 930 & 932)
- Leases of biological assets (Topic 905)
- Leases of inventory (Topic 330)
- Leases of assets under construction (Topic 360)

To meet the definition of a lease, a contract must grant the customer the **right to control the use** of an **identified asset** for a period of time in exchange for consideration.



ACCOUNTING FOR DIFFERENT LEASE TRANSACTIONS

For a full guide, including practical examples, of accounting for different potential lease transactions, arrangements, and scenarios, see BDO's **Topic 842, Leases** guide.

Identified Asset: In order to have an identified asset, a contract must either explicitly or implicitly specify the asset. Similar to prior requirements, an asset is not considered specified if the supplier has the right to substitute similar assets during the term of the contract and therefore maintain control.

However, under the new standard, supplier substitution rights are considered substantive (i.e., there is not an identified asset and therefore, there is not a lease), as described in ASC 842-10-15-10 only if the supplier (a) has the practical ability to substitute alternative assets throughout the period of use *and* (b) would benefit economically from the substitution. A supplier's right to substitute the asset only on or after a particular date or event, for repairs and maintenance, or based on the availability of a technical upgrade, is not considered a substantive substitution right.

In addition, the standard explains that if the asset is located at the customer's premises, the costs associated with substituting the asset are generally higher than they would be when located at the supplier's premises, and therefore are more likely to exceed the benefits associated with substituting the asset; thus, the substitution right would not be substantive. If the customer cannot determine whether a substitution right is substantive, the customer must presume that the substitution right is *not* substantive (that is, there is an identified asset, and the entity must evaluate the other conditions to determine whether there is a lease).

The requirement that a right of substitution provides economic benefits to the supplier for it to be substantive is new and may require significant judgment. As a result of this guidance, more contracts may be considered leases than under prior guidance. This determination becomes more important under the new guidance due to the balance sheet implications for the lessee.

Right to Control The Use: In addition to relating to an identified asset, the contract must convey to the customer the right to control the use of the identified asset. A customer has the right to control the use of an identified asset when it has both (a) the right to obtain substantially all the economic benefits from the use of the asset (the economic criterion) and (b) the right to direct the use of the asset (the control criterion).

A customer can obtain economic benefits from the use of an asset directly or indirectly in many ways, such as by using, holding, or subleasing the asset. The economic benefits from using an asset include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits that could be realized from a commercial transaction with a third-party.

A customer has the right to direct the use of the asset if (1) it can direct, including change, how and for what purpose the asset is used throughout the period of use, or (2) when the relevant decisions are predetermined, if the customer either designed the asset in a way that predetermined its use, or the customer has the right to operate the asset. The relevant decision-making rights to consider include, for example, the right to change the type of output produced by the asset, when or where the output is produced, whether the output is produced, and how much output is produced, if any.

Both the economic and control criteria are evaluated within the defined scope of the customer's right to use the asset. Terms that limit the use of the asset a certain way (for example, specifying a maximum amount of usage of the asset) or that protect the supplier's interest in the asset (such as requiring the customer to follow industry standard operating procedures, or requiring notification of changes in how or where the asset will be used) do not, in isolation, prevent the customer from having the right to direct the use of the identified asset.

For example, if a customer enters into a contract for the use of a data center for a 10-year period, restrictions within the contract limiting the number of fibers that can be used will not prevent the customer from directing the use of the fibers if, within that defined scope of the contract, the customer, for example, has exclusive use of the fibers throughout the two years (i.e. the economic criterion is met), and the customer decides how the fibers are used (i.e. the power criterion is met).

General Business Implications of Topic 842

GENERAL IMPACT ON TECH ENTITIES

Every entity that leases property, plant, or equipment will be affected by Topic 842 to some degree. Nevertheless, those with large operating lease obligations will likely feel the most impact. According to the IASB, listed entities using IFRS Standards or U.S. GAAP are **estimated** to have around $3.3 trillion of lease commitments, over 85 percent of which do not currently appear on their balance sheets. Most of those leases will now need to be recognized on the balance sheet under the new standard.

In addition to impacting large tech businesses, the new rules will affect all other tech entities such as startups and mid-sized businesses that rely on leasing due to tight budgets or limited funding. Many of these businesses may face a bigger compliance burden than their larger counterparts, simply due to their limited accounting, financial reporting, investor relations, and IT resources.

Tech businesses can expect to experience a challenging transition, simply because they will have to comply with the new standard in addition to all the other regulations they're already subject to—including various intellectual property, consumer protection, and anti-competition laws; specific limits imposed on Internet companies and social media and video platforms; the EU's newly enacted General Data Protection Regulation (GDPR); and more. How heavy a compliance burden an entity faces will depend significantly on how well it has tracked its lease transactions and assets to date.

EXTERNAL STAKEHOLDERS IMPACT

One of the most significant impacts the new accounting standard will have on businesses is on their financial reporting, namely the balance sheet: Lessees can expect a major increase in the number of assets and liabilities that must be recorded on their balance sheets, depending on the volume of leases and significance of lease payments. This increase may affect other financial metrics, including Return on Assets, interest coverage or operating leverage if there are changes in lease classification, and potentially some of the financial ratios incorporated in loan covenants, such as debt to equity. While the FASB decided to characterize operating lease liabilities as operating liabilities rather than debt, and—based on outreach performed with stakeholders—noted that a significant portion of loan agreements are on a "frozen" or "semi-frozen" GAAP basis, entities nevertheless should engage in conversations with lenders and other stakeholders to determine how the adoption of the new standard will impact their relationships.

Case-in-Point: Microsoft **announced** last year that adopting the new rules would add an estimated $5 billion of right-of-use assets and lease liabilities for operating leases to its 2016 balance sheet—or about 5-6 percent of the $85.3 billion in revenue it earned in 2016.

The added transparency on the balance sheet and footnote disclosures about an entity's leasing activities may result in added user scrutiny to the extent the amounts recognized on the balance sheet differ significantly from what users previously estimated through constructive capitalizations or other methods. Entities that have a substantial increase in reported liabilities could experience cost increases or potential barriers to financing future capital asset acquisitions, if financial institutions view these changes negatively.

As such, while most investors and financial partners are aware of the new standard (and currently adjust an entity's financial statements for the effect of operating leases), entities should still take the time to explain these extra reported liabilities to ensure there are no lingering questions or uncertainties. They should remind stakeholders that while the standard does change the accounting methodologies, it does not change the actual economics or logistics of a lease transaction (i.e. the terms and conditions and rights and obligations remain the same), nor the business reasons behind entering, renewing, or terminating the lease. Thus, company executives must assure investors that the core operations and fundamentals of their business are still the same, regardless of the balance sheet changes.

CONDUCTING AN IMPACT ASSESSMENT

The magnitude to which the standard impacts each entity depends on myriad considerations, including its industry, international activities, current contract terms, available resources, internal controls, and more. As such, it's critical that entities conduct an impact assessment before beginning the compliance process. This assessment should involve all relevant stakeholders in the entity, including accounting, tax, financial reporting and planning, operations, procurement, legal, IT, and real estate. A critical component of this impact assessment will be to educate all relevant internal stakeholders on what a lease is for accounting purposes, so that the entity has identified a complete population of leases subject to the new requirements.

Equally important is the lessee's communications with its external auditors. Because of the complexity involved, it's critical that entities keep their external auditors involved throughout the entire planning and implementation process.

Impact on Tech Entities

Tech entities, which are often both lessors and lessees, will be significantly affected by the new leasing standard.

SCOPE

While not comprehensive, common (or potential) lease arrangements employed by tech entities that will need to be evaluated under the new standard include:

Commercial Real Estate

When it comes to space, tech often needs more of it. The rapid expansion of tech campuses around Silicon Valley, as well as high growth startups, has led to increased demand for rental buildings, floors, and co-working spaces in recent years. Last year saw a particularly aggressive bout of leasing for the industry, with several tech entities, including Facebook, Amazon, Google, and Dropbox, signing over 3 million square feet of leases in San Francisco alone— marking it the fourth-most-active leasing year on record, according to Cushman & Wakefield. The evaluation of whether contracts for the use of real estate meet the definition of a lease generally will be straightforward.

The length of building leases varies widely; while typical lease terms are 5-10 years in class A buildings, rapidly growing tech entities often prefer shorter term leases—2-4 years—to allow for flexibility and unexpected short-term growth. Lessees will need to work with their accounting teams to figure out how best to optimize their real estate portfolio while minimizing the impact to their balance sheets.

IT Systems & Equipment

With the rapid pace of technology advancement, many tech entities choose to lease their IT equipment—including computers, servers, storage, and network machines—as opposed to purchasing them. Leasing is usually ideal for entities that do not wish to purchase the equipment upfront or maintain it through future updates and repairs.

Both capital and operating leases are popular with equipment leases. Capital leases are usually longer term and are for assets that do not easily become technologically obsolete. Operating leases, on the other hand, are often shorter term and typically involve assets that may require more frequent upgrades, like computer and office equipment.

As lessees determine how to account for both types under the new rules, they may reconsider their current strategy of leasing vs. buying IT equipment, and whether one might be more advantageous in the long term.

Data Center & Colocation

Leasing space from a data center to host company servers and related equipment is a common practice among tech entities, as data centers can provide them with access to uninterrupted power, reliable data connectivity, and physical and data security. The largest turn-key wholesale data center leases last year were all signed by tech entities, including Facebook, Microsoft, Apple, Google, and Uber, many of which were in Northern Virginia; this region continues to be the world's largest data center market, according to North American Data Centers.

Entities may have to exercise significant judgment when assessing whether certain data center and colocation arrangements count as leases under the new standard. Much of it will depend on the specific contract terms and conditions. Nevertheless, one key consideration will be whether there is an identified asset. For example, does the customer have a physically distinct space in the data center (e.g., 5,000 square feet physically separated from other spaces in the data center)? If not physically distinct, does the customer have the right to use substantially all the capacity space of the data center (e.g., 95,000 square feet of a 100,000 square feet data center)? Does the supplier have substantive substitution rights throughout the period of use (e.g., the supplier has the practical ability to change the space allocated to the customer and would benefit economically from substituting that space to accommodate other customers?). If there is an identified asset, the entity will need to determine whether the customer meets the economics criterion and power criterion. If so, the contract will be, or will include, a lease.

Cloud Computing Services & Software Licenses

Subscription-based cloud computing services have skyrocketed in popularity in recent years—especially "as-a-service" type offerings (i.e. Software-as-a-Service, Platform-as-a-Service, and Infrastructure-as-a-Service), in which entities pay monthly subscription fees to cloud providers for access to their infrastructure, platforms, and applications. Cloud computing services can also include arrangements in which an entity reserves a certain amount of server capacity in a data center for a certain number of years.

Internal-use software and hosting arrangements obtained for internal use are outside the scope of Topic 842. Instead, their accounting is governed in ASC Subtopic 350-40*, Intangibles—Goodwill and Other—Internal-Use Software*. Nevertheless, arrangements for cloud computing services may include multiple elements, including a lease of servers and/or other IT equipment. Accordingly, tech entities will need to determine whether such arrangements include embedded leases. A key consideration will be whether there is an identified asset. For example, is there a specified asset or can the supplier really use any of its IT equipment at its own discretion to fulfill the service to the customer? Is the customer essentially contracting for capacity on the supplier's servers and other IT equipment that the supplier has the right to use to also serve other customers? If there is an identified asset, the entity will need to determine whether the customer meets the economics criterion and power criterion. If so, the contract will be, or will include, a lease.

OTHER IMPORTANT CHANGES

There also are additional important changes brought by the new standard for which entities will need to create or update systems, processes, and controls. These changes include, but are not limited to, the following:

- The identification of components in a contract is not the same as in prior U.S. GAAP. For example, while property taxes, insurance, and maintenance previously were considered executory costs and were part of the lease element, under the new standard, property taxes and insurance are not components of a contract, while maintenance is a non-lease component (unless a practical expedient not to separate is elected, which is by asset class). The change in components identified, if any, will affect the amounts allocated to each component of the contract, including what is included as lease payments, which, in turn, will have a direct impact on the accounting for the lease (e.g., effect on lease classification and amounts recognized on the balance sheet).
- While both lessees and lessors will have to update their accounting for the lease when there is a modification that is not accounted for as a separate contract, the new standard also includes requirements for lessees only that did not exist in prior U.S. GAAP; that is, the reassessment requirements for the lease term and purchase options and other remeasurement requirements for the lease payments for which lessees will need new processes and controls in place.
- The accounting for sale and leaseback transactions is significantly different from prior U.S. GAAP.
- The determination about whether a lessee is deemed the accounting owner of a build-to-suit transaction has changed significantly.

Impact Beyond Accounting

The new standard will have numerous implications on an entity beyond accounting, with the potential to affect everything from contract negotiations to tax strategy to business processes and controls.

When doing an impact assessment, entities should understand Topic 842's impact on their:

- Leasing strategy
- Planning and budgeting
- Debt covenants and other contracts
- Internal and external communication
- Lease management software and processes

LEASING STRATEGY

Topic 842 will significantly impact entities' short and long-term leasing strategies. Conducting a lease portfolio analysis as part of the compliance process can help entities determine which lease transactions and management processes they wish to continue, change, or end. This could include consolidating certain leases or lessors, renewing current leases, or applying for new leases with better rates.

A few examples of potential leasing strategy changes are outlined below.

Buying vs. Leasing

The new standard is not intended or expected to cause a large percentage of entities to switch from leasing to buying critical assets, nor is it meant to be a deterrent to growing a business. After all, many of an entity's primary motivators in leasing equipment—from preserving capital to obtaining access to needed resources—remain unchanged under the new rules.

Nevertheless, the new standard's requirement to include both operating and finance leases on balance sheet as assets and liabilities *is* a big change from the old rules. Depending on how significant the changes are, some entities may find that it's more cost-effective for them in the long term to buy certain assets than to lease them. Entities will need to weigh the benefits and associated risks of both when deciding whether to keep or change their current lease transactions.

Lease Reduction or Extension

The standard could impact whether lessees decide to shorten or extend their lease term. Some lessees might want to shorten their lease terms to under 12 months to keep them from appearing on their balance sheets. While this could help entities maintain the status quo, it also means more frequent lease renegotiations and the risk of potentially having increased costs each time. It's important to remember as well that short-term leases are not scoped out of the new leases standard, as described in the overview section. Others might want to extend those that are on the border of being characterized as operating or finance leases, so that they can be categorized as finance leases; the latter is usually more preferable because amortization and depreciation are excluded from certain performance metrics such EBITDA, but operating lease payments are treated as normal period expenses. Entities will need to weigh the pros and cons of each outcome before deciding.

FINANCIAL AND TAX REPORTING IMPLICATIONS

As mentioned prior, the biggest impact of the new standard is the requirement that all leases be recognized on the balance sheet of lessees' financial statements (except for those with a short-term lease exemption). For example, if a leasing arrangement qualifies as a "true lease" for tax purposes, the recognition of a right-of-use asset and corresponding lease liability for an operating lease now will result in the recognition of new deferred tax assets or liabilities because the lessee would neither have a tax basis in the right-of-use asset, nor a lease liability for federal income tax purposes.

The magnitude of the deferred taxes recognized initially will depend on several factors, including the lessee's accounting policy election related to non-lease components (e.g., maintenance service) and initial direct costs. The new standard permits an accounting election to include non-lease components in the measurement of the lease liability. The deferred income taxes initially recognized would be higher when lessees elect to include non-lease components in the measurement of the lease asset and liability.

Under the new standard, the definition of initial direct costs is significantly narrowed to only include incremental costs of a lease that would have not been incurred if the lease had not been obtained. Consequently, certain initial costs now will be expensed for accounting purposes but are still required to be capitalized for income tax purposes, thereby creating additional temporary differences and deferred income taxes. However, federal tax law allows for an immediate deduction of de minimis costs incurred to acquire an asset (i.e., up to $5,000 of the entire cost for taxpayers with applicable financial statements). This tax deduction allowance might be suitable for small value leases (e.g., certain office equipment and computers).

While the balance sheet change is very significant, the income statement change is less pronounced. This is because the FASB decided to retain the income recognition pattern of a typical operating lease which is going to continue to be a single cost recognized on a straight-line pattern over the lease term.

However, lease expense (i.e., single lease cost) is unlikely to be the same for tax purposes. The tax deduction for advance rents, stepped rents, and rent bonuses will be determined based on the terms of the agreement and the taxpayer's current accounting methods. Therefore, the book-to-tax expense difference will be accounted for as a temporary difference under Topic 740 to be reconciled with the movement in the deferred tax balances related to the lease liability and asset. For finance leases, the income statement recognition of total lease cost remains the same as under prior guidance.

Deferred income tax accounting for sale and leaseback transactions by the seller-lessee could also see some changes. The new standard requires the application of the principles in the new revenue recognition standard, Topic 606, to determine whether the transaction qualifies for sale accounting. If the transaction fails sale accounting, the transaction is accounted for as a financing transaction by both the seller-lessee and the buyer-lessor. It is possible that some sale and leaseback transactions that meet the current tax law requirements for sales to seller-lessees and purchases to buyer-lessors might fail the requirements in Topic 606 for sales accounting, creating more temporary differences for lessees and lessors. In those situations, a seller-lessee will recognize current taxable income but will have a deferred tax asset representing the future inclusion of book income but not taxable income (the seller-lessee would have a liability for accounting purposes). Conversely, certain sale and leaseback arrangements involving real estate that cannot be accounted for as sales under prior guidance may achieve sales accounting treatment under Topic 606, further impacting deferred income taxes.

SELECTED INCOME TAX CONSIDERATIONS

Reporting entities implementing the new standard will also need to consider and track the classification of their leases for tax purposes—i.e. the domestic federal and/or foreign income tax classification of all leases. Proper classification of leases for income tax purposes is required to ensure accurate application of Topic 740 and to avoid recognition of uncertain tax benefits related to leases.

There might also be current tax implications such as re-determination of state & local income taxes due to changes in apportionment factors used to allocate income to states and local jurisdictions.

Additionally, a reevaluation of the tax classification of existing leases might necessitate applying for accounting method changes for federal tax purposes. Currently, Rev. Proc. 2016-29 provides an automatic change procedure for taxpayers to change the classification of sale, lease, or financing transactions.

Summary of Potential Tax Implications

In summary, lessees and lessors should consider the following list of potential tax implications, which is not all-inclusive:

Accounting for Income Taxes

- Recognition of new deferred tax assets and liabilities for previously unrecorded lease-related assets and liabilities.
- New or revised book/tax differences included in the provision for income taxes.

International Tax

- Track temporary differences for earnings and profits (E&P) purposes.
- Identify statutory to U.S. GAAP differences and understanding accounting in the local foreign trial balance.

Federal Income Tax

- No change to current tax framework for recording leased property.
- When tax classification follows the book classification of leases (as operating, sales-type, or direct financing), the federal tax classification should be evaluated under federal tax principles to ensure tax classifications are sustainable.
- New or revised book/tax Schedule M adjustments.

State and Local Tax

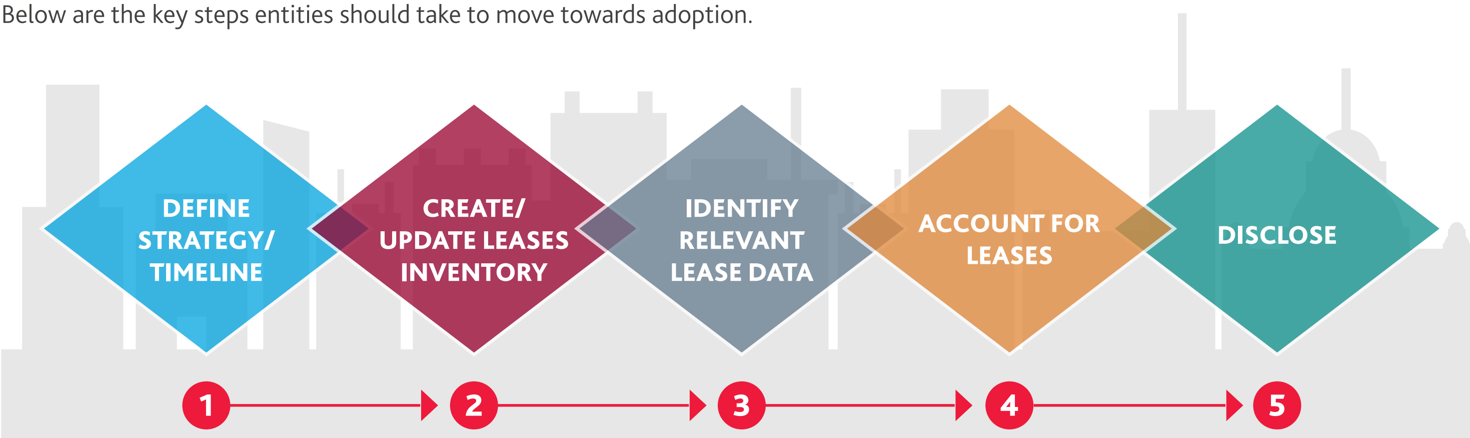
- Changes to classification of leased property for apportionment purposes.
- Evaluation of whether the new accounting for leases creates or changes sales tax obligation related to leased assets.
- Evaluation of whether leased property is included in the tax base subject to property taxes.

Because of the complexity involved, entities should keep their tax and accounting partners involved throughout the entire implementation process.

Preparing for Adoption

Entities preparing for the new standard have many challenges ahead. Lessors must be careful not to underestimate the impact of Topic 842, as there are some important changes. Lessees will need to carefully go through their contracts portfolio and identify any (including embedded) leases that may not have been identified as leases historically but may be under the new rules.

Below are the key steps entities should take to move towards adoption.



1. Define a strategy and timeline.

Similar to the adoption of any standard, good project management and planning is paramount. Entities should devise a realistic timeline and set up steering committees and/or project teams to track and report their progress. More time and effort will be required to implement the new standard than most entities anticipate, so it's critical to begin early, even with the new transition method that the FASB recently issued.

2. Create and/or update a centralized inventory of all lease contracts and assets.

With the many processes involved in lease management—leasing, renewing, and exiting—entities must create an accurate, comprehensive inventory of all their current leases. This may or may not be an easy process, depending on the robustness of an entity's existing processes and controls in place under prior GAAP and considering the less significant impact that operating lease accounting had in the past.

Global entities with international operations and leases will have additional challenges. They will need to keep specific considerations in mind, such as leases denominated in foreign currencies and/or written in foreign languages.

Entities can begin the process by examining their current tracking systems and assessing the accuracy and completeness of their leasing data today. They can then create a single electronic system for all their leases. Once a central lease inventory is created, they can reevaluate their current lease transactions to determine if their lease strategy makes sense. Data analytics can help lessees identify potential cost savings opportunities, including consolidating vendors or reexamining current lease procurement processes and negotiations.

3. Identify what additional data is needed for compliance, including disclosures, and consider changes to existing processes, roles, and controls.

As entities put together their lease inventories, they will need to either update or develop new systems for keeping track of their data moving forward. Some entities may need to keep multiple sets of books to satisfy different requirements and needs.

Unfortunately, many entities simply aren't equipped currently to handle the level of tracking the new standard requires; in fact, many public entities still manage their lease accounting in spreadsheets. In adopting the new standard, entities should think about upgrading their existing lease management system to include an accounting module, and/or consider how they will track and store lease data in the future, including how to meet the new and enhanced disclosure requirements. Entities also need to set up strong internal controls to meet the Sarbanes-Oxley Act requirements and ensure they are continuing to follow all the usual rules of compliance, in addition to the new rules. Depending on the entity, this process of identifying systematic gaps and updates can take up to 9 to 12 months.

4. Analyze and account for leases.

Once entities have set up a centralized lease inventory with all the necessary data and updated their processes, they must update their lease accounting according to the new standard.

Entities will need to determine which transition method they want to elect for the initial application of the new leases standard, and which practical expedients to elect. Entities are reminded that the practical expedient not to reassess whether a contract is, or contains, a lease (which is included in the package of practical expedients) does not grandfather errors. Accordingly, entities that wish to take advantage of the package of practical expedients should ensure they have a complete population of leases identified in accordance with Topic 840.

Entities also should be aware of the accounting differences between existing leases versus new leases entered into, on, or after the effective date of the new standard. For example, lessees will recognize existing operating leases on the balance sheet using the *minimum rental payments* as applied under Topic 840, rather than using the *lease payments,* as defined under Topic 842. However, after the effective date, if those existing leases are modified and not accounted for as a separate contract, or the lessee is required to remeasure the lease payments, then the lessee should use the *lease payments* as defined under Topic 842 in accounting for those leases starting at the effective of the modification or the remeasurement date and should no longer use *minimum rental payments*.

Because the FASB's standard is not fully converged with the IASB's, multinational entities must also be aware of the differences and be prepared to comply with both, depending on the jurisdiction. See the "Resources & Contacts" section for comprehensive guides on the FASB and IASB lease accounting rules.

5. Prepare the required disclosures for stakeholders.

The new standard requires entities to prepare disclosure statements intended to enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. Many of these requirements are incremental to the prior requirements and will likely require significant effort and judgment to prepare, especially the information about significant assumptions required from both lessees and lessors and information about risk management related to residual assets required from lessors.

The level of detail and how much emphasis to place on each of the various requirements is a matter of judgment, and entities must aggregate or disaggregate disclosures to ensure that useful information is neither obscured by presenting a large amount of insignificant detail nor by aggregating items that have different characteristics. More extensive disclosures are appropriate for entities for which leasing is a significant portion of their business.

Below are elements that lessees and lessors should include in their disclosures (the list is not all inclusive).

LESSEES:

- Information about the nature of their leases (general description of leases, basis, and terms of variable lease payments, options, etc.);
- Information about significant assumptions and judgements made;
- Information about significant leases that have not yet commenced;
- Information about lease liabilities separately for operating and finance leases:
  - Maturity analyses
  - Weighted-average remaining lease term
  - Weighted-average discount rate
  - Cash flows and supplemental noncash information
- Amounts related to lease cost (including any amounts capitalized), such as finance lease cost (segregated between amortization and interest), operating lease cost, short-term lease cost (except those with a lease term of one month or less), and variable lease cost;
- If practical expedients related to short-term leases and the separation of lease and non-lease components are elected, disclose that fact and related details.

LESSORS:

- Information about the nature of its leases (general description of leases, basis and terms of variable lease payments, options, etc.);
- Information about significant assumptions and judgements made;
- Tabular presentation of:
  - Profit or loss at commencement (sales-type and direct financing)
  - Interest income on receivables and residual assets (sales-type and direct financing)
  - Lease income (operating)
- Maturity analysis of lease receivables (sales-type and direct financing) or lease payments (operating);
- Narrative disclosure about risk management for residual assets.

Entities should train their employees on the changes and set up a communication strategy to keep all stakeholders up to date on the latest developments.

How BDO can Help

BDO's Accounting & Reporting Advisory Services (ARAS) practice provides clients with a wide range of high-level consultative services, including financial reporting, evaluation of complex accounting and reporting issues, implementation of new accounting standards, evaluation and accounting for business transactions, and more.

The firm's strategic alliance with CoStar Real Estate Manager provides entities with an end-to-end solution to help them meet Topic 842's looming deadlines. CoStar's proven Lease Manager software service provides the complete functionality needed to manage and report on real estate, equipment and other leased assets. Delivered in a software-as-a-service (SaaS) format, it offers out-of-the-box functionality that includes balance sheet impact, classification tests, amortization schedules, journal entry processing, and GL system integration. To ensure compliance with Sarbanes Oxley's requirement to demonstrate effective internal controls and procedures for financial reporting, CoStar's platform completes an SSAE 16 audit annually.

Paired with BDO's technical experience, entities can use the end solution to greatly accelerate the process of analyzing and classifying leases for the new requirements and bring them into compliance before the deadline.

To learn more about how BDO can help, view our resources below, or contact any one of our professionals.

RESOURCES & CONTACTS

Additional resources related to lease accounting include:

BDO USA: **Accounting & Reporting Advisory Services** practice page

BDO USA: **BDO Knows FASB: Topic 842, Leases** guide

BDO Global: **IFRS in Practice: IFRS 16 Leases** guide

For questions related to matters discussed, please contact:

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