Lease accounting survey

Preparing for implementation

Executive summary

The new lease accounting standard proposed by the Financial Accounting Standards Board (FASB) fundamentally changes the rules that govern accounting for both equipment and real estate leases. Under the FASB proposal, companies would be required to recognize the assets and liabilities resulting from leases of more than 12 months in duration based on the present value of lease payments. Among its many provisions, the proposed lease accounting standard also affects the disclosure requirements for the recognition of lease-related expenses and income.

After receiving more than 750 comments on its original Exposure Draft (ED) issued in August 2010, FASB issued a revised ED on May 16, 2013, with comments due by September 13, 2013. Almost 600 comment letters have been received on this revised ED. As a result, the final lease accounting standard could be issued in 2014 with an effective date no sooner than 2017. However, Russell Golden, chairman of the US-based FASB, has recently acknowledged that continuing pushback from commercial real estate, large multinational companies, small businesses and other stakeholders will likely require more changes to the most recent ED. "It's clear we're going to have to change something, and we should change something," Golden said at a meeting with the Private Company Council (PCC), a group advising the FASB on accounting issues.[1]

To better understand the expected impacts and implementation issues that may result from the FASB's proposed lease accounting standard, Deloitte[2] conducted a survey in June 2013 of 138 executives at companies that are lessees or lessors. The companies participating represented a wide variety of industries, including 44 percent with annual revenues of $500 million or greater ("larger companies"), and 56 percent with annual revenues of less than $500 million ("smaller companies"). The current survey follows a 2011 Deloitte survey of real estate lessees and lessors about the first lease accounting ED.

Findings

- **Widespread Impacts Expected.** Executives expect the proposed lease accounting standard to have significant impacts on their company's financial reporting with 58 percent expecting impacts on the balance sheet, 53 percent on financial statement disclosures, and 46 percent expecting impacts on their company's financial ratios.

- **Financial Ratios Affected.** Among those who expect impacts on their company's financial ratios, 71 percent expect an impact on their company's Debt to Equity ratio with 52 percent expecting an impact on their company's Return on Assets (ROA) percentage. Overall, equipment and real estate lessees expect more of an impact on these and other financial ratios than do real estate lessors.[3]

- **Additional Reporting Burden.** A majority of executives predict the proposed standard would place a significant reporting burden on lessees of real estate (88 percent) and equipment (85 percent), while roughly three-quarters also anticipated a significant reporting burden on lessors of equipment (73 percent) and real estate (71 percent).

- **Few Companies Prepared to Comply.** Almost 80 percent of executives felt that implementing the proposed accounting standard would be difficult with only six percent believing their company was extremely or very well prepared to comply. Less than 10 percent of executives reported their company had fully or significantly implemented many of the key implementation tasks.

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[1] CoStar Group. "No End In Sight for Implementing New Lease Accounting rules". 9 October 2013. http://www.costar.com/News/Article/No-End-In-Sight-for-Implementing-New-Lease-Accounting-Rules/153197.

[2] As used in this document, "Deloitte" means Deloitte Transactions and Business Analytics LLP and Deloitte & Touche LLP, which are separate subsidiaries of Deloitte LLP. Deloitte Transactions and Business Analytics LLP is not a certified public accounting firm. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

[3] The results for equipment lessors are not provided since the survey respondents only included 19 equipment lessors.

- **Little Progress on Implementation.** Only one percent of executives at real estate lessees felt their companies were extremely or very prepared to comply with the proposed standard, down from nine percent in the 2011 survey. Among real estate lessors, 13 percent believed their company was extremely or very prepared versus the five percent result reported in the 2011 survey.

- **Extended Timeframe for Implementation.** Fifty-two percent of executives expect implementation would take one year or longer. Executives appear to realize the extent of the work required. In the 2011 survey, only 33 percent of executives at real estate lessees expect implementation would require one year or longer, but that figure increased to 50 percent in the 2013 survey.

- **Concerns over IT Systems and Lease Data.** Many of the implementation challenges considered extremely or very challenging relate to IT capabilities and lease data compliance with the following concerns cited: ensuring the sufficiency and integrity of the necessary lease data elements for accounting (57 percent), adequacy of IT systems (55 percent), and creating a complete (electronic) inventory of documentation for equipment leases (47 percent) and for real estate leases (44 percent).

Widespread impacts expected

Many executives expect the proposed lease accounting standard to have widespread impacts on their company (Figure 1).

Significant Changes to Financial Statements. Since the proposed standard requires recognition of leases as assets or liabilities, it was not surprising that the balance sheet led the list, with 58 percent of the executives surveyed expecting a major or significant impact. The other areas frequently cited were disclosures (53 percent) and financial ratios (46 percent).

Executives at companies that are lessees were more likely than real estate lessors to anticipate impacts in many areas. For example, roughly two-thirds of executives from equipment and real estate lessees expect major or significant impacts on their balance sheet compared to 43 percent for real estate lessors. Similarly, roughly half the executives from companies that are lessees expect major or significant impacts on their company's financial ratios, while only 32 percent of those from real estate lessors agreed (Figure 2).

However, when it comes to impacts on the income statement, real estate lessees appear to be less concerned than they were two years ago. Perhaps due to greater understanding of the proposed accounting standard, and to certain specific revisions made within the ED, the percentage of executives from real estate lessees that expect major or significant impacts on their income statement dropped from 49 percent in the 2011 survey to 29 percent in 2013.

Since companies will be required to estimate the executory or operating costs for their full-service/gross real estate leases, an important issue is what portion of a company's real estate lease portfolio consists of full-service leases as opposed to net leases. Executives at companies where less than half their real estate lease portfolio consists of full-service leases were much more likely to anticipate major or significant impacts on the balance sheet (70 percent vs. 48 percent), disclosures (64 percent vs. 40 percent), financial ratios (52 percent vs. 36 percent), and the income statement (34 percent vs. 21 percent).

Figure 1. Expected major/significant impacts of lease accounting standard

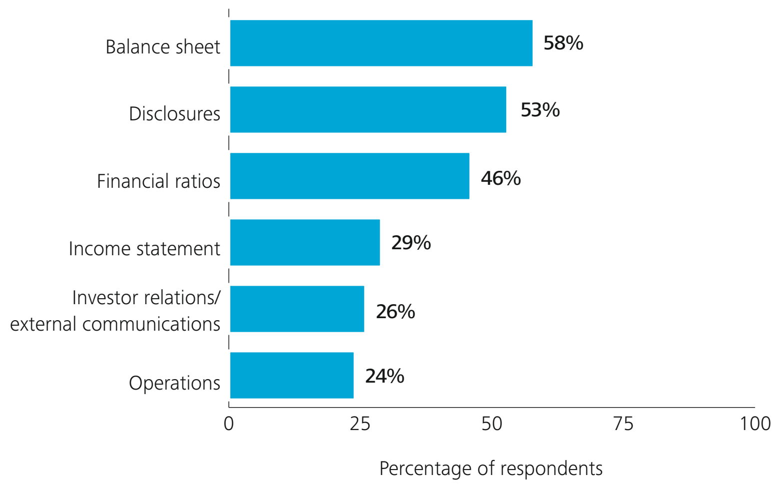
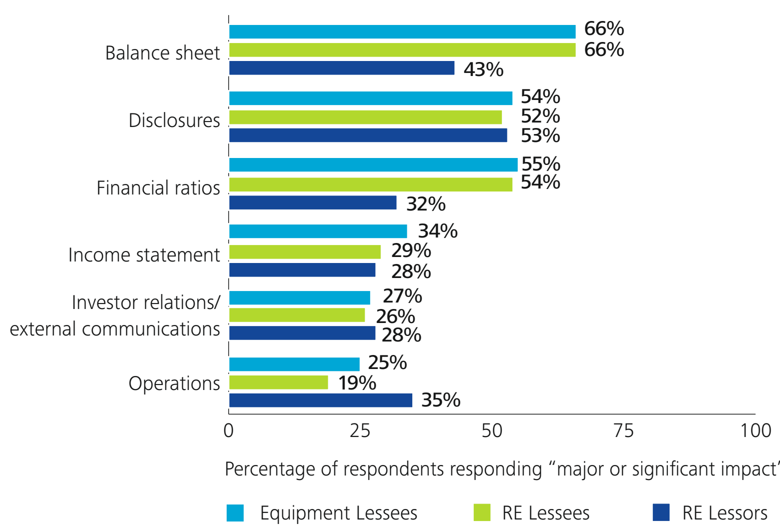


Figure 2. Expected impact of lease accounting standard



Note: Equipment lessors are omitted since the sample only included 19 companies in this category.

Expected Changes in Financial Ratios. Executives that expect impacts on their financial ratios also expect material impacts on their Debt to Equity ratio (71 percent) and ROA (52 percent). (Figure 3)

Lessees also anticipate that specific financial ratios would also be affected. Roughly 80 percent of equipment and real estate lessees believed there would be material impacts on their company's Debt to Equity ratio (compared to 60 percent for real estate lessors), roughly two-thirds expected impacts on ROA (compared to 23 percent for real estate lessors) and roughly 45 percent expected impacts on enterprise value/EBITDA (compared to 23 percent for real estate lessors).

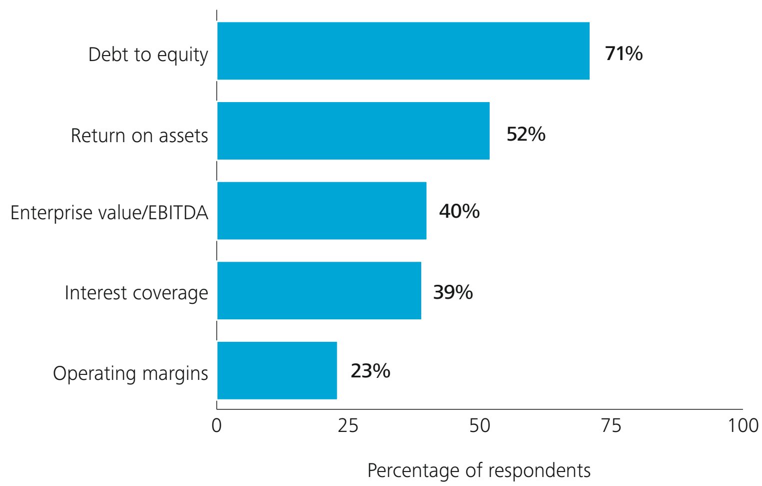
Potential Difficulties in Obtaining Financing. Forty-two percent of executives believe the proposed standard would make it more difficult for their company to obtain debt financing. Many executives at equipment and real estate lessees also expected the proposed standard to create issues with their bankers. Roughly two-thirds of these executives believed the impacts on their financial ratios from the proposed accounting standard would affect their existing debt covenants, while 40 percent thought their bankers would adjust their debt covenants to account for the new standard and 21 percent expected they would want to negotiate new concessions.

Increased Tax Liability. One-quarter of the executives thought the proposed accounting standard would result in increased income taxes for their company, while 38 percent expected an increase in deferred taxes.

Real estate lessees were more likely to expect increased tax liability. Roughly 30 percent of the executives at real estate lessees expected an increase in income taxes compared to only seven percent of those at real estate lessors.

Additional Reporting Burden. A large majority of executives felt the proposed lease accounting standard would create a significant reporting burden on lessees of real estate (88 percent) and equipment lessees (85 percent); while roughly three-quarters thought it would also place a significant burden on lessors of equipment (73 percent) and real estate (71 percent).

Figure 3. Financial ratios expected to be materially affected
Base = Respondents who expected impacts on financial ratios



Fewer Renewal Options and Shorter Lease Terms Expected in Real Estate Leases. Fifty-eight percent of executives from companies that are real estate lessors expect that the proposed lease accounting standard will result in real estate lessees seeking to reduce or eliminate renewal options, while 39 percent of those from real estate lessees agreed. Roughly 40 percent of both real estate lessors and lessees expect that the proposed standard will lead real estate lessees to seek to reduce lease terms. When real estate lessees and lessors were asked how they believed lessors would seek to recover their investments in tenant improvements and other rent concessions if lease terms were shortened, 39 percent predicted increased rents, while 30 percent thought rent concessions would be reduced or no longer offered.

Shift to Purchasing from Leasing. Among executives at equipment lessees and lessors, 53 percent thought the proposed standard would make companies either much more likely or somewhat more likely to purchase equipment rather than lease. Similarly, 41 percent of those at real estate lessees and lessors expect that companies would be more likely to purchase rather than lease single tenant occupied facilities.

Lease portfolios face significant compliance issues

The companies participating in the survey reported having many leases that could pose significant issues when complying with the proposed accounting standard.

Operating Leases. Under the proposed accounting standard, the assets and liabilities resulting from leases that are currently accounted for off-balance sheet as "operating" leases will need to be recognized on the balance sheet. On average, companies reported that 73 percent of their equipment lease portfolios and 88 percent of their real estate lease portfolios are currently accounted for as operating leases.

Full-Service/Gross Real Estate Leases. On average, executives reported that 44 percent of their real estate leases are full-service or gross leases (i.e., include all or a portion of operating expenses).

Determining Executory Costs. The proposed lease accounting standard would exclude from capitalization the executory costs or service components (operating expenses) from the total rental charges in the lease. Yet, only about one-third of executives believed operating expenses or service components were readily determinable in three-quarters or more of their leases. This is a greater challenge for lessees: only about 20 percent of equipment and real estate lessees said operating expenses or service components were readily determinable in three-quarters or more of their lease portfolios compared to 53 percent for real estate lessors.

Contingent Rent Provisions. Roughly 70 percent of executives said their company had real estate leases with index or CPI-based contingent rent provisions. For equipment leases, 32 percent of companies reported having these provisions.

Renewal and Early Termination Options. For equipment leases, 74 percent of companies reported having leases with renewal or early termination options, including 36 percent where three-quarters or more of their equipment leases have such options. For real estate leases, 92 percent of companies reported having leases with early termination or renewal options.

Significant Economic Incentive to Exercise Options. Under the proposed standard, both lessees and lessors would be required to determine whether the lessee has a "significant economic incentive" to exercise any options to extend or terminate the lease. On average, the executives surveyed estimated that in 30 percent of their equipment leases and 43 percent of their real estate leases the lessee would have a significant economic incentive to exercise the options.

In making the determination that a lessee has a significant economic incentive to exercise lease renewal or early termination options, the proposed standard requires companies to consider four types of factors: *contract-based* (e.g., advantageous or disadvantageous lease provisions), *asset-based* (e.g., significant improvements already invested), *entity-based* (e.g., the location of the specialized nature of the asset), and *market-based* (e.g., market rates compared to lease rates). However, only 53 percent of executives felt their company was able to employ these four factors to determine whether the lessee has a significant economic incentive to exercise options in equipment leases and 63 percent in real estate leases.

Implementation challenges

Many executives expected that complying with the proposed lease accounting standard will be challenging and few feel their company is currently prepared.

Compliance Considered Difficult. Almost 80 percent of executives felt their company would find it difficult to comply, including 26 percent that felt it would be extremely difficult. Only six percent of executives felt their company was "extremely" or "very prepared" to implement the proposed standard (Figure 4).

Companies generally appear not to have made much progress since the 2011 survey. Among real estate lessees in the current survey, only one percent said they were extremely or very prepared to comply, down from nine percent in the 2011 survey. Among real estate lessors, the picture was only slightly brighter. In 2013, 13 percent of executives at real estate lessors considered their company to be extremely or very prepared, up somewhat from five percent in 2011.

Little Progress on Implementation. When executives were asked to what extent their company had completed a series of specific implementation tasks only 23 percent said they had fully, significantly or partially implemented lease inventory/data gathering/data validation and only 19 percent had achieved this level of progress on conducting an accounting review. For other implementation tasks — such as training, establishing a program management team, and upgrading/integrating IT systems — less than 10 percent of companies had even partially implemented them (Figure 5).

Given the slow progress to date, 52 percent of executives believed implementation would require one year or longer, while only 14 percent thought it could be accomplished in less than six months. Perhaps because they understand more clearly what is required to comply, executives now believe implementation will take longer than they had estimated in the prior survey. For example, in the 2011 survey, only 32 percent of executives at real estate lessees expected implementation would take one year or longer, but in 2013 that figure jumped to 50 percent.

Figure 4. Complying with proposed lease accounting standard

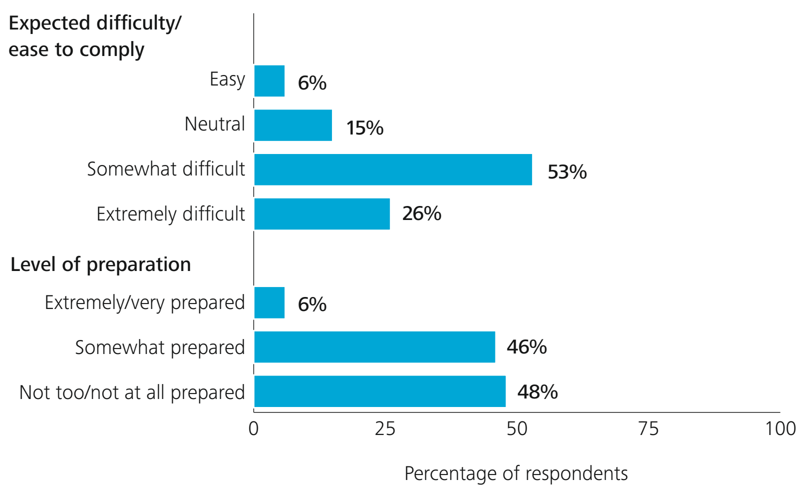
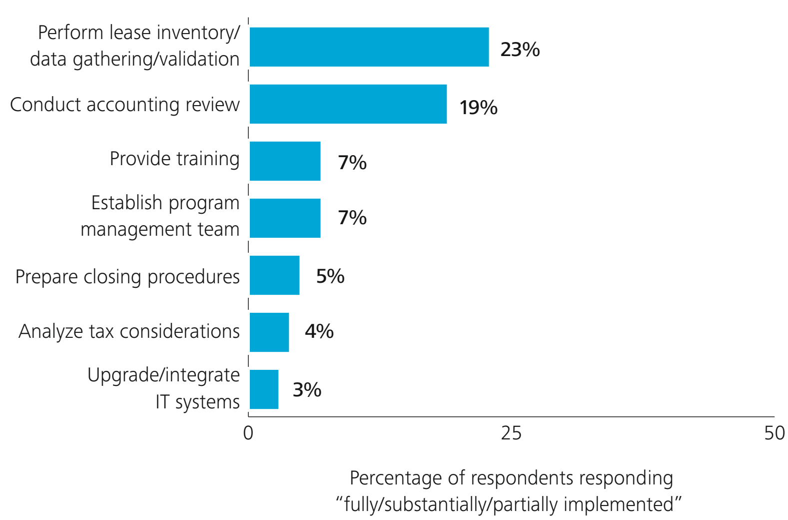
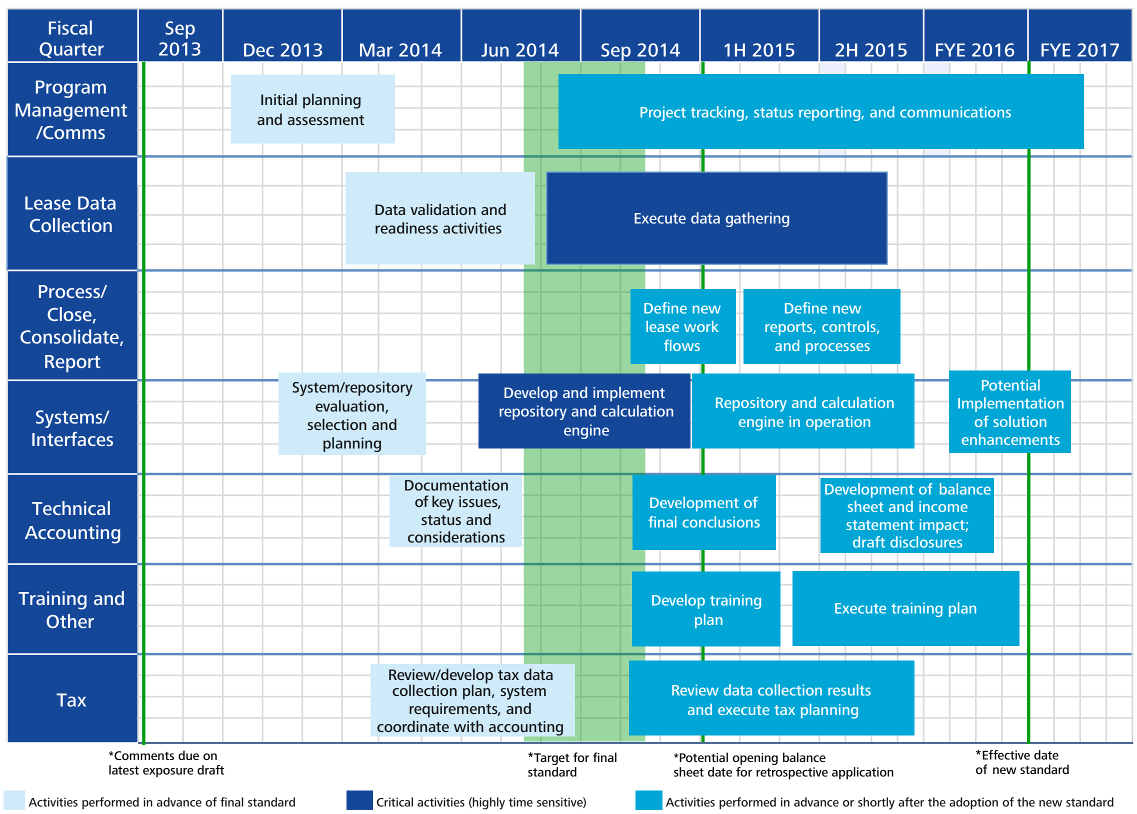


Figure 5. Extent of completion of implementation tasks



Compliance will require companies to undertake a variety of activities in such areas as lease data collection, reporting, IT systems, technical accounting, and training, as well as overall program management of the implementation process. Companies can benefit by developing a Lease Implementation Roadmap to help manage this complex process (Figure 6).

Figure 6. Illustrative Lease Implementation Roadmap — assume effective 1/1/2017

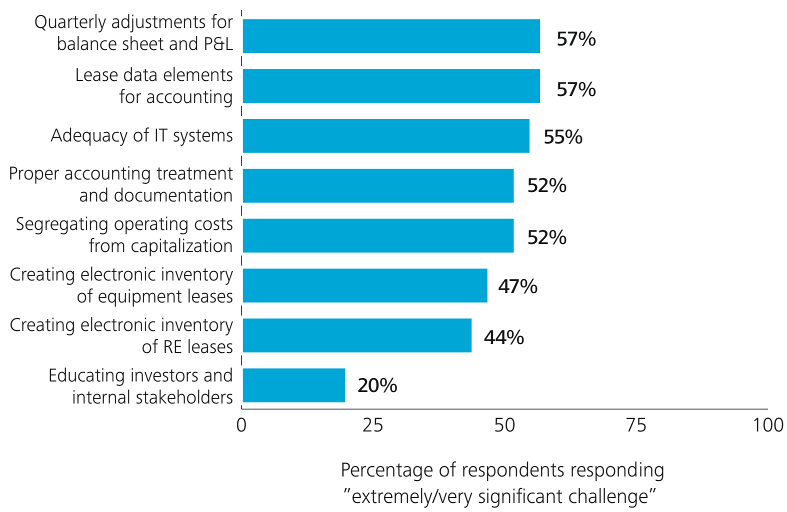


Variety of Challenges Anticipated. Many executives cited a wide a series of challenges in implementing the proposed standard. The issues considered extremely or very significant implementation challenges include: developing and instituting processes to evaluate quarterly adjustments/reassessments for the balance sheet and P&L (57 percent), analyzing the proper technical accounting treatment and supporting documentation (52 percent), and evaluating lease and service contracts by segregating executory (operating) costs from capitalization (52 percent) (Figure 7).

Concerns over Adequacy of IT Systems and Lease Data. Some of the difficult compliance issues involve the additional demands the proposed standard will place on IT systems and lease databases. Companies will need to confirm the accuracy of the data in their lease databases and also ensure that their databases contain such lease attributes as start/expiration dates, rent step-ups, early extension/termination options, and other areas. Executives considered several IT and lease data issues to present extremely or very significant compliance challenges including: ensuring the sufficiency and integrity of the necessary lease data elements for accounting (57 percent), ensuring the adequacy of IT systems (55 percent), creating a complete (electronic) inventory of documentation for equipment leases (47 percent), and creating a complete (electronic) inventory of documentation for real estate leases (44 percent). (Figure 7)

Executives from larger companies were more likely than those from smaller companies to consider IT and lease data issues to present extremely or very significant challenges as indicated by the following responses: ensuring the sufficiency and integrity of the necessary lease data elements for accounting (67 percent vs. 48 percent), ensuring the adequacy of IT systems (62 percent vs. 49 percent), and creating a complete (electronic) inventory of documentation for real estate leases (55 percent vs. 33 percent).

Figure 7. Challenges in implementing proposed lease accounting standard



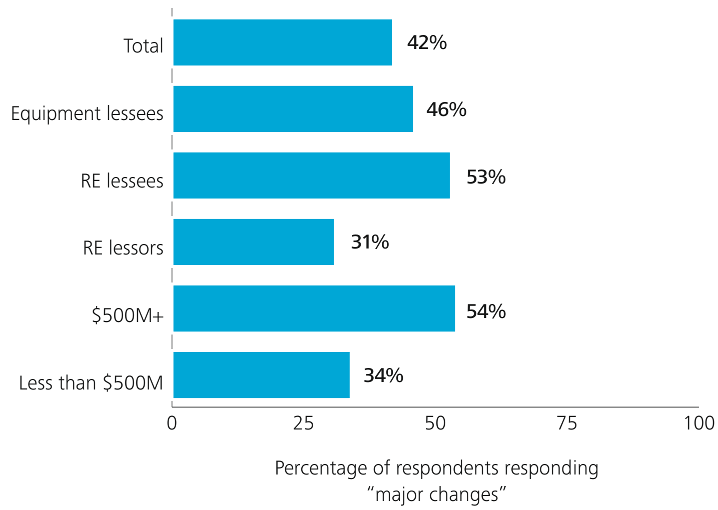
Large companies can face greater compliance challenges since they typically have larger and more complex lease portfolios. For example, larger companies reported a larger portion of their equipment lease portfolios were operating leases than did smaller companies (81 percent vs. 65 percent). On the other hand, executives at smaller companies may not fully appreciate the extent of the changes to their IT systems and lease databases that will be required to comply with the rule.

Organizing the lease data needed for the proposed lease accounting standard may require companies to establish a complete inventory of equipment and real estate lease contracts and amendments, aggregate data, and convert lease database text fields into numeric fields. Only 24 percent of the executives said they were extremely or very confident in the completeness and integrity of the lease attribute data at their company. Executives at real estate lessees (15 percent) and at larger companies (17 percent) were even less confident. A growing recognition of the demands that will be placed on their lease databases by the proposed standard may explain why in 2013 executives at real estate lessees were less confident in the completeness and integrity of their company's lease attribute data (15 percent) than they were in the 2011 survey (32 percent).

As a result, 42 percent of executives believe their company would need to make major changes in its lease data gathering process and procedures in order to comply. The expectation that major changes to data gathering will be needed was more common among real estate lessees (53 percent) and larger companies (54 percent). (Figure 8)

To comply with the proposed standard, many executives expected their company would need to make significant changes to its IT systems as well: 12 percent expected to acquire a new IT system, while 20 percent expected a major upgrade and 34 percent a minor upgrade. Equipment and real estate lessees were more likely than real estate lessors to anticipate installing a new system or making a major upgrade: 16 percent of real estate lessees expected to acquire a new IT system compared to just three percent of real estate lessors, while 24 percent expected to undertake a major upgrade compared to 15 percent for real estate lessors.

Figure 8. Extent of changes needed in lease data gathering to comply



Conclusion

For many companies, the proposed lease accounting standard could have far-reaching impacts on their balance sheet and financial ratios, such as Debt to Equity and ROA. Both lessees and lessors are likely to face significant additional reporting burdens.

Few companies currently appear to be prepared to comply with the proposed standard and little progress has been made at completing the required implementation tasks. Chief among these will be confirming the completeness and integrity of lease data and that IT systems have the required capabilities.

Although the proposed standard could be approved in 2014 and to take effect no sooner than 2017, the complexity and extent of the changes that will be required to accounting procedures, IT systems, and lease data gathering processes suggests that companies should soon begin to address these significant implementation challenges.

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