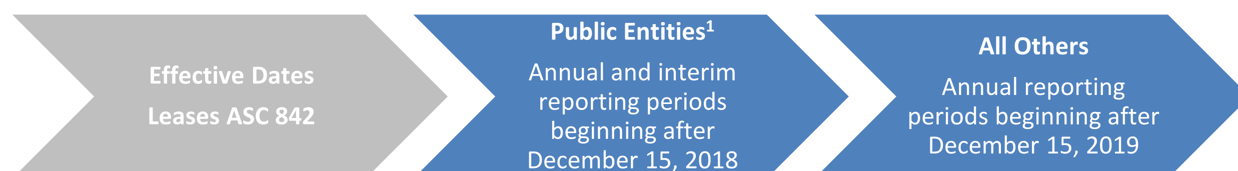
Lessor Presentation & Disclosure Requirements

The public entity[1] adoption deadline for the new guidance in Accounting Standards Update (ASU) 2016-02, *Leases* (Topic 842), is drawing closer. This is the first major overhaul of lease guidance since 1973 and implementation and documentation will be substantial undertakings for entities in all industries with significant lease activity. The effect on each company will depend on the nature and volume of its leases. The updates are more significant for lessees; however, changes were made to the lessor accounting model to align it with changes to the lessee model and the new revenue recognition standard, most notably for sale leaseback transactions.

Feedback from early adopters has prompted the Financial Accounting Standards Board (FASB) to consider additional relief. FASB already issued an ASU related to land easements and recently finalized new transition expedients and a set of technical corrections to clarify certain aspects of the new model. Another exposure draft is expected shortly to address treatment of costs paid by lessees.

This paper focuses on a lessor's presentation and disclosure requirements. Lessors will be required to provide more information about the nature of their leases and subleases. In addition, Accounting Standards Codification (ASC) 842 expands lessor disclosure obligations to include in interim-period financial statements. These new qualitative and quantitative disclosures should be considered upfront in the planning process. Entities can then develop a plan to fill any information gaps and implement new processes, policies, controls and systems to capture pertinent lease data and comply with these requirements. Most notably, the new rules require rollforward information that current systems may not be able to handle.

Do not underestimate the time, effort and cost to implement these new rules.



SAB 74 Disclosures

The U.S. Securities and Exchange Commission's (SEC) Staff Accounting Bulletin (SAB) No. 74, *Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period*, imposes financial statement disclosure requirements in advance of a company's adoption of a new accounting standard. In several speeches, SEC officials have made it clear they are looking for increasing levels of detail from SAB 74 disclosures as the effective date approaches.

In multiple public speeches, senior SEC officials noted they are looking for disclosures beyond the plain language of SAB 74. Statements that the new standard's effect is immaterial should reflect consideration of the new standard's full scope, which covers recognition, measurement, presentation and disclosure for lease transactions. The SEC staff expects to see the following in the upcoming SAB 74 disclosures:

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[1] *A public entity is defined as any one of these:*

- *A public business entity*
- *A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market*
- *An employee benefit plan that files or furnishes financial statements to the SEC*

- A comparison of current accounting policies to the expected new accounting policies
- The status of implementation. The status of the process should be disclosed, including significant implementation matters not yet addressed or if the process is lagging
- Consideration of the effect of new footnote disclosure requirements in addition to the effect on the balance sheet and income statement. A new accounting standard may not be expected to materially affect the primary financial statements; however, it may require new significant disclosures that require significant judgments
- Disclosure of the quantitative effect of new accounting standards if it can be reasonably estimated
- Disclosure that the expected financial statement effect of new accounting standards cannot be reasonably estimated
- Qualitative disclosures. When the expected financial statement effect is not yet known by a registrant, a qualitative description of the effect of the new accounting standard on the registrant's accounting policies should be disclosed

The SEC recognizes that SAB 74 disclosures are preliminary and subsequent changes in disclosed estimates will not be assumed to reflect a control deficiency relating to prior disclosures. A company's disclosures should evolve over time and be consistent with information provided to its audit committee and investors. As management completes portions of its implementation plan and develops an assessment of the anticipated effect, effective internal controls should be designed and implemented to timely identify disclosure content and ensure that appropriately informative disclosure is made. The SEC announced it will pay close attention to both the accounting policy footnote addressing the effect of adoption of the new generally accepted accounting principles (GAAP) and a company's quarterly disclosures of any material changes to internal controls over financial reporting, given the magnitude of the implementation process.

SEC officials emphasized that audit committees should be discussing the outside auditor's views about management's implementation efforts. Wesley Bricker, SEC chief accountant, pointedly observed in his American Institute of CPAs keynote address: "Particularly for companies where implementation is lagging, preparers, their audit committees and auditors should discuss the reasons why [implementation is lagging] and provide informative disclosures to investors about the status so that investors can assess the implications of the information. Successful implementation requires companies to allocate sufficient resources and develop or engage appropriate financial reporting competencies."

SAB 74 requirements only apply to public companies but can provide valuable insights to private companies on the size, scope and challenges in implementing this standard.

Presentation

The new lease standard has specific financial statement presentation requirements for leasing activity. Lessors are required to classify leases as sales-type, direct financing or operating leases. Presentation has not significantly changed from current guidance.

Balance Sheet

Sales-Type & Direct Financing Leases

In a sales-type or direct financing lease, the lessor derecognizes the leased asset and recognizes a lease investment on its balance sheet. A lessor's aggregate net investment should be presented separate from other assets on the lessor's balance sheet. Lease assets should be classified as current or noncurrent.

Operating Lease

A lessor should classify assets subject to operating leases as property, plant and equipment, *e.g.*, within buildings, or as a separate line item on the balance sheet, *e.g.*, assets subject to operating leases. As with other fixed assets, property subject to operating leases may be presented net of accumulated depreciation on the balance sheet, but the accumulated depreciation should be shown on the face of the balance sheet or disclosed in the notes to the financial statements. For operating leases with rents that change over time, the requirement to recognize rental income on a straight-line basis may generate a rent receivable or deferred rent revenue on the lessor's balance sheet. A lessor also may need to recognize a prepaid asset on the balance sheet arising from initial direct costs that the lessor will recognize as an expense over the lease term. Lessors should present a rent receivable, deferred rent or prepaid initial direct costs with items of similar maturities on a classified balance sheet, *e.g.*, with other prepaid items associated with long-term contracts.

Income Statement

Sales-Type & Direct Financing Leases

A lessor in a sales-type lease will recognize a selling profit or loss—as well as the initial direct costs—at lease commencement. The profit or loss recognized should be presented in a manner that best reflects the business model associated with the leased asset. For example, a manufacturer that leases assets as a means of realizing value from goods it would otherwise sell may present the revenue and cost of goods sold on a gross basis. Alternatively, if a lessor leases assets to generate revenue by providing financing, it may be appropriate to present the net profit or loss in a single line item. A lessor in a direct financing lease should defer the selling profit and initial direct costs, both of which are included in the net investment of the lease. Amortization of the initial direct costs should be recorded as a reduction of interest income rather than as an expense.

Operating Lease

A lessor should present rental income from an operating lease net of the amortization of rent receivables, deferred rent or prepaid initial direct costs. A lessor should continue to measure the underlying asset subject to an operating lease in accordance with other GAAP. Depreciation of the underlying asset should be presented gross and should not offset rental income.

Cash Flow Statement

A lessor is required to classify cash receipts from all lease payments, regardless of lease classification, as operating activities.

Disclosures

The lease standard includes a disclosure objective intended to provide users of financial statements with information adequate to assess the amount, timing and uncertainty of cash flows arising from leases. Both quantitative and qualitative disclosure requirements will increase for lessors and lessees. These new disclosures, bolded below, may require new processes and internal controls. Further, the disclosures are subject to audit and, for public entities, will be in scope for management's report on internal controls.

Lessors must consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each requirement. Aggregation should be at a level so useful information is not obscured by including a large amount of insignificant detail or by aggregating items that have different characteristics. For companies with extensive significant leasing activities, more comprehensive disclosures will be expected.

While ASC 842 requires only certain lessor disclosures to be made in all interim financial statements, Regulation S-X requires SEC registrants to provide both the applicable lessor and lessee annual and interim disclosures in each interim period included in the entity's quarterly reports on Form 10-Q in the year of adoption of a new accounting standard.

A lessor should disclose information about all of the following:

Qualitative Disclosures

- Nature of leases
  - A general description of those leases
  - The basis and terms and conditions on which variable lease payments are determined
  - **The existence and terms and conditions of options to extend or terminate the lease**
  - **The existence and terms and conditions of options for a lessee to purchase the underlying asset**
- **Significant judgments**
  - **The determination of whether a contract contains a lease**
  - **The allocation of the consideration in a contract between lease and nonlease components**
  - **The determination of the amount the lessor expects to derive from the underlying asset following the end of the lease term**
- Lease transactions between related parties. Related-party lease guidance has been updated; disclosure applies only with legally enforceable terms and conditions
- **Risk management information on the residual value of its leased assets, including:**
  - **Risk management strategy for residual assets**
  - **Carrying amount of residual assets covered by residual value guarantees (excluding guarantees considered to be lease payments for the lessor)**
  - **Any other means by which the lessor reduces its residual asset risk, *e.g.*, buyback agreements or variable lease payments for use in excess of specified limits**

Quantitative Disclosures

- Lease income recognized in each annual and interim reporting period, in a tabular format, including:
  - **For sales-type leases and direct financing leases, profit or loss recognized at the commencement date (can be gross or net basis) and the interest income either in aggregate or separated by components of the net investment in the lease**
  - **For operating leases, lease income relating to lease payments**
  - Lease income relating to variable lease payments not included in the measurement of the lease receivable. (Previous guidance only required disclosure of the total of contingent rentals included in income in each period presented)
- The components of its aggregate net investment in sales-type and direct financing leases, *e.g.*, the carrying amount of its lease receivables, its unguaranteed residual assets and any deferred selling profit on direct financing leases

In addition to the items noted above, further disclosures are required for lessors depending on the type of lease:

- Sales-type and direct financing leases
  - Explain significant changes in the balance of its unguaranteed residual assets and deferred selling profit on direct financing leases

    - Maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessor shall disclose a reconciliation of the undiscounted cash flows to the lease receivables recognized in the statement of financial position (or disclosed separately in the notes)

- Operating leases
    - Maturity analysis of lease payments, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. This maturity analysis should not include sales-type leases and direct financing leases—they must be broken out separately
    - Disclosures required by Topic 360 on property, plant and equipment separately for underlying assets under operating leases from owned assets. FASB concluded leased assets often are subject to different risks than owned assets. The lessor should disaggregate by significant class of underlying asset subject to lease because the risk related to one class of underlying asset may be very different from another, *e.g.*, a building versus an airplane

BKD has prepared a library of **BKD Thoughtware®** on lease issues. Visit our Hot Topics page to learn more. If you have questions about the new rules, contact your BKD advisor.

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Appendix A – SEC SAB 74 Examples

United Rentals, Inc. 1Q 2018

In March 2016, the Financial Accounting Standards Board ("FASB") issued guidance ("Topic 842") to increase transparency and comparability among organizations by requiring i) recognition of lease assets and lease liabilities on the balance sheet and ii) disclosure of key information about leasing arrangements. Some changes to the lessor accounting guidance were made to align both of the following: i) the lessor accounting guidance with certain changes made to the lessee accounting guidance and ii) key aspects of the lessor accounting model with revenue recognition guidance. Topic 842 will be effective for fiscal years and interim periods beginning after December 15, 2018, and early adoption is permitted. A modified retrospective approach is required for adoption for all leases that exist at or commence after the date of initial application with an option to use certain practical expedients. We expect to adopt this guidance when effective.

As discussed in note 2 to our condensed consolidated financial statements, most of our equipment rental revenues, which accounted for 84 percent of total revenues for the three months ended March 31, 2018, will be accounted for under the current lease accounting standard ("Topic 840") until the adoption of Topic 842. While our review of the equipment rental revenue accounting under Topic 842 is ongoing, **we have tentatively concluded that no significant changes are expected to the accounting for most of our equipment rental revenues upon adoption of Topic 842.**

Under Topic 842, our operating leases, which include both real estate and non-rental equipment, will result in lease assets and lease liabilities being recognized on the balance sheet. We lease a significant portion of our branch locations, and also lease other premises used for purposes such as district and regional offices and service centers. We expect that the quantification of the amount of the lease assets and lease liabilities that we will recognize on our balance sheet will take a significant amount of time given the size of our lease portfolio. While our review of the lessee accounting requirements of Topic 842 is ongoing, we believe that the impact on our balance sheet, while not currently estimable, will be significant.

TAL International Group, Inc. 1Q 2018

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2016-02 ("ASU No. 2016-02"), Leases (Topic 842) that replaces existing lease guidance. The accounting applied by lessors under Topic 842 is largely unchanged from previous GAAP. Some changes to the lessor accounting guidance were made to align both of the following: i) the lessor accounting guidance with certain changes made to the lessee accounting guidance and ii) key aspects of the lessor accounting model with revenue recognition guidance. These changes will become effective for the Company for periods beginning after December 15, 2018. **The Company is currently evaluating the effect the guidance will have on the Consolidated Financial Statements, but does not expect any material impact to its financial statements.**

CIT Group Inc. 1Q 2018

ASU 2016-02, *Leases (Topic 842)* *Issued February 2016*	• Lessees will need to recognize all leases longer than twelve months on the consolidated balance sheets as lease liabilities with corresponding right-of-use assets. For Income Statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit thresholds. • Lessor accounting remains similar to the current model, but updated to align with certain changes to the lessee model (e.g., certain definitions, such as initial direct costs, have been updated) and the new revenue recognition standard. Lease classifications by lessors are similar, operating, direct financing, or sales-type. • The ASU requires both quantitative and qualitative disclosures regarding key information about leasing arrangements. The new standard must be adopted using a modified retrospective transition, and provides for certain practical expedients. Transition will require application of the new guidance at the beginning of the earliest comparative period presented. Early adoption is permitted.	• Effective for CIT as of January 1, 2019. • CIT will need to determine the impact where it is both a lessee and a lessor: • Lessor accounting: CIT is analyzing the impact of changes to the definition of 'initial direct costs' under the new guidance. The new standard has a narrower definition of initial direct costs, which will result in CIT recognizing increased upfront expenses offset by higher yield over the lease term. CIT is currently evaluating the bifurcation of certain non-lease components from lease revenue streams. If goods or services are determined to be a non-lease component and accounted for under ASC 606 or other applicable GAAP guidance, the income recognition may differ from current accounting. • Lessee accounting: CIT is continuing to evaluate the impact of the amended guidance on its Condensed consolidated financial statements. CIT expects to recognize right-of-use assets and lease liabilities for substantially all of its operating lease commitments based on the present value of unpaid lease payments as of the date of adoption. • CIT management has assembled a project committee to assess the impact of this guidance. Initial scoping and assessment is complete and CIT is continuing to evaluate the impact on its consolidated financial statements and disclosures.