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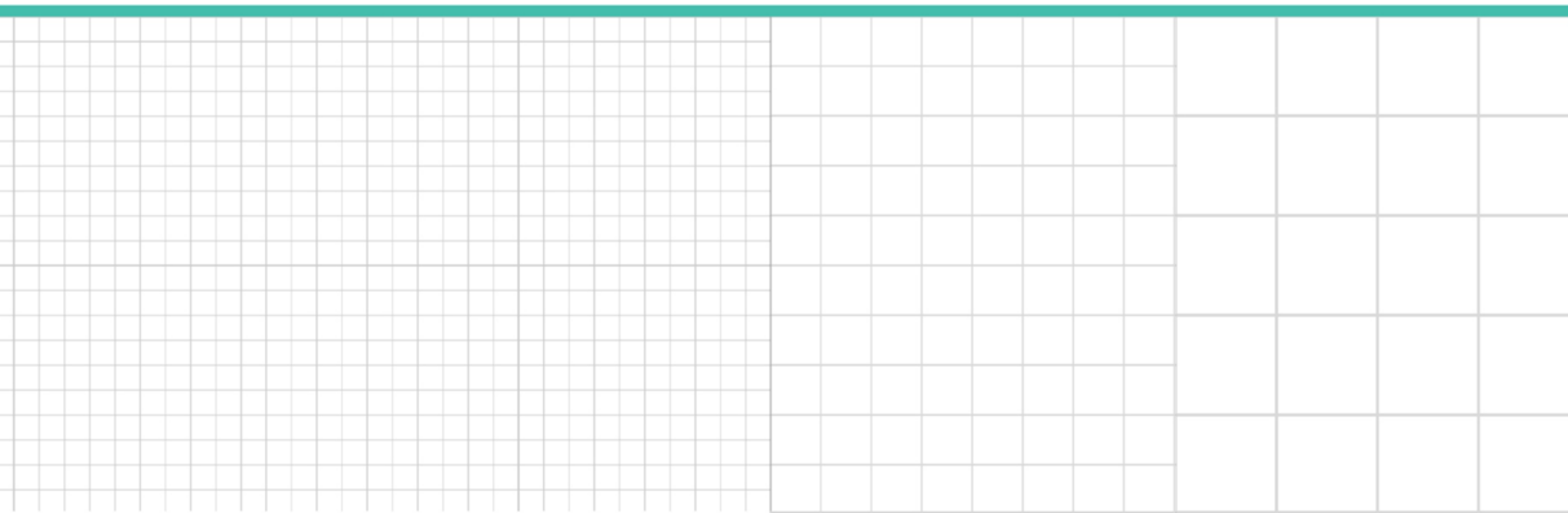

Implementing New Lease Accounting Guidance, and Effects on Comparability in M&A

Contributed by [Frank Lazzara](), [Seth Fliegler](), and [James Brennan](), Duff & Phelps

The recent release of new lease accounting rules by the Financial Accounting Standards Board and the International Accounting Standards Board significantly impacts public and private companies. These changes also influence the accounting and negotiations of mergers and acquisitions.

Introduction

FASB's ASC 842—Lease Accounting Standards Update No. 2016-02—changes how companies report assets and liabilities within their financial statements. For example, one of the purchase price elements of an M&A transaction is the target's working capital, which, exclusive of cash and seller-assumed short-term debt, is typically calculated by subtracting current liabilities from current assets.

In setting the expected working capital that will be transferred along with the target at closing, the parties will agree to a "peg," typically derived from an average of the target company's historical balance sheets, using somewhere between a trailing 12 and trailing 24 months from the most current financials available during the prospective buyer's due diligence.

While all the target company's assets and liabilities are relevant to the acquiror's acquisition analysis, those that translate into a source or use of cash within 12 months from closing are perhaps most meaningful in determining adjustments to the negotiated purchase price. Accounts receivable, inventory, trade A/P, and accrued liabilities are those items that most closely correlate to the recurring cash-flow potential of the subject entity.

The parties must also factor the balances of prepaid assets, other receivables, and short-term liabilities, such as those associated with historically capitalized lease obligations. However, these other asset and liability balances are somewhat less volatile and fluctuate from period to period, primarily due to elapsed time and the maturity schedule of the subject asset or liability.

For example, the current balance of a prepaid asset, much like a short-term note liability, is often tied to the expected occurrence of an event within 12 months of the financial statement date, such as a principal repayment or the application toward a recurring company expense (i.e., general and administrative expenses such as utilities or rent). Similarly, the current portion of a capitalized lease liability was relatively predictable, experiencing decreases from the monthly payment of lease obligations and increases courtesy of the passage of time.

Mechanically, the increases resulted from the time-driven reclassification from long-term liabilities to short-term liabilities for each passing month. So, in the case of current lease obligations that were an element of a target company's balance sheet, unless there was a meaningful change to their property, plant, and equipment financing strategy, there was little variability in the amount of their current lease obligation liability from the pre-closing measurement period to the closing date. That premise, however, will experience a significant change in the near term due to the revised accounting rules for leases.

Sea Change

The IFRS Foundation estimates that implementation of ASC 842 – Leases (Accounting Standards Update No. 2016-02), issued by FASB in Feb. 2016 and effective as of Jan. 1, 2019, will affect recorded liabilities on the balance sheets of public company lessees by a cumulative increase of approximately $3 trillion. It is reasonable to expect an amount equal to or exceeding that level of increase for the population of non-publicly filed financial statements in the U.S.

In the near term, certainly for participants in M&A transactions, this guidance necessitates modifying the manner in which parties develop (pre-closing) and measure (post-closing) the target and closing working capital of acquired entities that routinely enter into operating leases with terms exceeding 12 months. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election not to recognize lease assets and liabilities. However, for leases with

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related parties and month-to-month leases, it is important to determine if the arrangement is truly month-to-month. ASC 842-20 Lessee.

One constituency impacted by the guidance is lessees who are estimating their incremental borrowing rate, a critical input to be used in the asset and liability capitalization calculations. While not a significant impact to lessors, the impact to lessees is evidenced in both their balance sheets and within their financial and reporting infrastructure.

Lessees will continue to perform an analysis of their contracted lease terms to determine classification as either an operating or a financing lease. Currently, there are only two designations for leases, which fundamentally differ only as to whether the lease payments are recorded as interest expense and depreciation (i.e., for a finance lease) or rental expense (i.e., "lease cost" for an operating lease).

However, in either case, whether finance or operating, the lessee must now use the lease terms to also calculate the liability requiring capitalization as well as the newly introduced right of use asset. Ross Prindle, global head of Duff & Phelps' real estate advisory group, notes that "[t]he estimation of an incremental borrowing rate is based on both the credit of the reporting entity as well as the associated remaining term of the leases that are to be put on the balances sheet." There is, therefore, significant judgment required as the required capitalization exercise is not a "one-size-fits-all" undertaking.

Classification

Although reminiscent of the old SFAS 13 paragraph 7 "Criteria for Classifying Leases" tests (codified into the predecessor guidance, ASC 840) that gave rise to a "capitalized lease," the ASC 842 classification criteria (ASC 842-10, 25-2) have been modified as follows, stating that a lessee shall classify a lease as a finance lease when the lease meets any of the following criteria at lease commencement:

- The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.
- The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.
- The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

Under the previous guidance, if the lease being analyzed were to meet any of the (now revised) classification guidance above, the lessee would have had to start the process of calculating and recording a lease liability and a fixed asset. In connection with this analysis, the lessee would also have had to determine the useful life of the asset for purposes of calculating depreciation, and set up an equal and offsetting liability that would be liquidated over the term of the lease as payments were made.

One of the prime deliverables in support of a client's lease-adoption engagements is to work with lessees to calculate the requisite inputs, such as the discount rate implicit in the lease, the fair value and estimated useful life of the subject right of use asset, the identification of any purchase and renewal options, and the development of the cash flow models to derive the present value of the lease liabilities and ROU asset.

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Daunting as the above may sound to the lessee who has traditionally avoided the math necessitated by a requirement to capitalize a lease, the potentially bad news is getting worse. The classification and calculation exercises summarized above are now required for all leases, whether classified as finance or operating.

It must be stressed that until this point, this article has only addressed the ASC 842 requirements for prospective calculations and accounting of newly executed leases entered into after the ASC 842 effective date. However, the guidance also has transition requirements. Notably, for public filers who are adopting ASC 842 in 2019, their comparative balance sheets issued in 2019 will require the retrospective amendment to their prior year's balance sheet, which is presented as a comparative financial statement in the year of adoption (i.e., 2019 includes a side-by-side 2018 balance sheet).

The "Transition" guidance in ASC 842's paragraph 842-10-65-1d. provides for the following:

> An entity shall adjust equity at the beginning of the earliest comparative prior period presented, and the other comparative amounts disclosed for each prior period presented in the financial statements, as if the pending content that links to this paragraph had always been applied, subject to the requirements in (h) through (dd).

Similarly, and particularly relevant to private filers who routinely enter into leases that are structured to avoid the capitalization treatment in the predecessor guidance and may be considering an M&A transaction, their 2020 financial statements will require a retrospective application to their 2019 balance sheet.

Impact of Cash Flow

Astute buyers and their financial advisers are well-versed in modeling cash flow forecasts that routinely convert GAAP financials into cash flow, which is of major significance to informing their purchase price formulation and decision.

A scenario that should not be ignored is one in which the preparation of a working capital peg and the associated post-closing true-up, while complying with the routinely required "GAAP, consistently applied" standard inserted into their purchase agreement, may give rise to creative interpretations when dealing with the pre- and post-effective date of ASC 842.

For example, consider the derivation of a working capital peg for a private company acquisition target that occurs during the 2018–2019 period, with a closing scheduled for Q1 2020. It is likely that the financial statements analyzed in diligence and used to arrive at the working capital target to be conveyed at closing will contain leases that have historically received operating lease treatment. The 2020 closing working capital calculation, prepared in accordance with GAAP and consistently applied, will likely pose an interpretive quandary.

Namely, should the working capital be calculated in accordance with GAAP, effective in 2020? If not, then the preparer will have run afoul of the purchase agreement. Alternatively viewed from the seller's perspective, preparing the closing working capital true-up, a task most often delegated to the buyer post-closing in accordance with GAAP in 2020, will give rise to a potentially significant level of current lease obligation liability. However, this immediately produces a purchase price adjustment in favor of the buyer.

Alternatives to Consider

In the category of working capital dispute avoidance, there have generally been two paths available to parties to minimize the prospect of a disagreement regarding this concept of "variable GAAP." Specifically, although consistently applying GAAP to the preparation of a target entity's balance sheet, the rules have undergone a transition that traverses the pre- and post-closing period giving rise to an unintended "inconsistency" by virtue of the consistent compliance to the effective rules at the date of financial statement preparation.

Those two paths are to prepare for (rehearse) for the closing, or exclude (or carve out) those accounts that pose the dispute hazard.

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Option 1: Take a Cue from GAAP

In the context of lease accounting, the current guidance espouses for transition with a "mild restatement," that is, the application of lease accounting to the earliest period presented in the subject comparative balance sheet. With a 2020/2019 effective date for private company filers, the lessee will have to recast the application of ASC 842 to the first month of the presented balance sheet, or Jan. 2019. So, why not roll back the exercise for an additional 12 months?

Once a target company and its financial advisers are under way with the implementation of AC 842, which will entail the application of lease accounting's liability (and ROU asset) recognition provisions for all leases, rolling back for the 2018 period should not typically require that much additional effort and resources. This will provide for a longer trailing period for analysis, which should assuage the buyer, and eliminate the possible party disagreement about divergent liability recognition policies existing in the establishment of the pre-closing target, versus the post-closing measurement of such target.

Option 2: Carve it Out

While the skill required to craft an agreement that strikes a balance between a requirement for the preparation of financial statements in accordance with GAAP "except in the case of operating leases that meet the requirements of ASC 842" is not for the fainthearted, it may be the preferred option for certain, lower middle-market companies, whose entrepreneurial successes are as strong as their ability to comply with complex accounting is weak.

Conclusion

In either event, companies considering an M&A transaction should consult their financial advisers and plan for the implementation of ASC 842 in the manner most suitable to their financial accounting infrastructure and reporting expertise.

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