Private Equity & the New Leases Standard

The new leases accounting standard requires lessees to recognize virtually all leases on the balance sheet. Because of this, the way a private equity firm approaches its investments may change. Accounting Standards Update (ASU) 2016-02, *Leases*, requires lessees to record a liability for payment obligations under the lease and a corresponding right of use (ROU) asset for the right to use the leased asset during the lease term.

Lease classification criteria are substantially similar to the classification criteria for distinguishing between capital leases—now finance leases—and operating leases in existing U.S. generally accepted accounting principles (GAAP), but without the bright-line thresholds. This means that the income statement and metrics such as earnings before interest, taxes, depreciation and amortization (EBITDA) are expected to be minimally affected in comparison to today's standards. However, this does not mean the new leases standard will not have important implications.

This article provides insight into how the standard will affect the private equity (PE) sector, both from a lessee and lessor perspective.

Lease Costs Given Heightened Attention

Throughout the life cycle of acquisition, portfolio management and successful realization, PE firms focus on cost cutting. Along with labor costs and cost of goods sold, lease expenses are still the prime cost-cutting targets for business investments, and PE firms should understand the financial and operational effects from a lessee's perspective. For those PE firms investing in net lease property, changes to the leases standard are particularly important in managing their cap rate and tenant occupancy cost thresholds. Here are the primary reasons:

- **Financial Metrics** – PE firms are largely metric-driven, and financial metrics that use balance sheet elements will be affected by the balance sheet gross-up caused by putting all leases on the balance sheet. For example, the leverage ratio "total commitments (borrowings plus lease liabilities) to EBITDA" will likely increase for PE firms with significant off-balance sheet leases. The performance ratio "return on capital employed" (operating profit divided by the sum of equity, borrowings and lease liabilities) will likely decrease. These changes may require lender explanation to avoid debt covenant violations or to avoid providing the lender with an unanticipated leverage point in borrowing negotiations. Changes in these ratios also may alter incentive compensation payments or earn-outs.

  Because finance and operating leases affect the income statement differently, as is the case under current GAAP for capital and operating leases, lease classification will affect a PE's earnings-related ratios differently. In general, because a lessee's income statement is expected to remain similar to the presentation under current guidance, the effect on many income-based performance metrics will be limited.

- **Business & Economic Decisions** – Lease-versus-buy decisions may have been influenced by whether a transaction qualified for off-balance sheet treatment. Given that virtually all leases will be reported on the balance sheet under the new standard, companies may want to revisit their lease-versus-buy decision process. For example, lessees may expend more resources comparing lease rates to purchase prices and finance terms when buying is feasible. Lessees will likely give more prominence to considering additional leasing benefits such as the transfer of residual risk and moving tax benefits from a tax indifferent party, *e.g.*, an entity with a large net operating loss carryforward, to a fully taxable entity.

- **State Taxes** – Changes to reported asset balances may affect income apportionment among states, potentially resulting in additional income reapportioned to higher tax jurisdictions. State capital and net worth taxes also may increase because of the additional ROU assets recorded by putting virtually all operating leases on the books.

- **Sale Leaseback Transactions** – Accounting for sale and leaseback has substantially changed under ASU 2016-02. The updates apply to all assets—including real estate—and to both the buyer-lessor and the seller-lessee. For a sale to occur in the context of a sale and leaseback transaction, transfer of the asset must meet the requirements for a sale in the new revenue recognition guidance (Financial Accounting Standards Board Accounting Standards Codification 606). Real estate transactions that would not qualify for sale under existing guidance may qualify under the new guidance due to elimination of the continuing involvement rules. The opposite may be true for transactions involving other than real estate if the equipment sale/leaseback has a disqualifying repurchase option.

  PE firms wanting to replace a capital asset on the balance sheet (with the income statement effect of depreciation) with an ROU asset (with the income statement effect of lease expense, if operating, or interest and amortization, if financing) may consider involving legal counsel to review the sale and leaseback terms. Capital and ROU assets are both subject to impairment testing.

- **Related-Party Transactions** – The recognition and measurement of related-party leases will follow the same requirements as unrelated party leases—on the basis of legally enforceable terms and conditions. In existing GAAP, lessors and lessees are required to account for leases with related parties on the basis of the arrangement's economic substance, regardless of the existence of legally enforceable terms and conditions. The exercise of putting these leases on the balance sheet could be difficult when terms and conditions of the lease arrangement are undocumented or not at arm's length. To the extent that such lease terms are the only legally enforceable terms in a related-party lease, those terms would be all that would be accounted for in the lease.

- **Leases of Specialized Assets** – ASU 2016-02 adds an additional criterion to the lease classification test. A lessor should classify a lease as a sales-type lease when the underlying asset is of such specialized nature that it is expected to have no alternative use to the lessor at the lease term's end. If the asset is found to have no alternative use, the lessor will immediately recognize any gain from the asset sale in accordance with the requirements for a sales-type lease. From a lessee's perspective, the lease will be classified as a finance lease with interest and amortization income statement effects—versus classifying the lease as operating and recording the lease cost as an operating expense. The additional criterion may be relevant for entities with unique leased assets that may have previously classified the arrangements as operating leases.

- **Lease Versus Nonlease Components** – With virtually all leases on the balance sheet, a lessee's focus may shift from attempting to structure a lease as an operating lease instead of a capital lease—now "finance" lease—to attempting to structure arrangements that formerly involved leased assets as nonlease service arrangements. Where identification of a lease may not be straightforward, all parties will need to carefully apply the new lease definition to contracts. Under the new standard, a contract must provide the lessee with decision-making authority over the asset and the ability to substantially obtain all the economic benefits from the use of an identified asset. The criteria are complex and judgment will be required.

  - **Property Taxes & Insurance** – Payments that are reimbursements or payment of the lessor's costs, such as property taxes and insurance payments, do not represent a separate good or service. Hence, these costs would not be considered a nonlease component for which consideration is allocated in an arrangement that includes a lease. Instead, they would be included in the initial ROU asset and lease liability calculations. Lessors may want to consider structuring these payments as variable lease payments not initially recognized as part of the lease liability.

Why Plan Now?

Strategic leasing will consider many elements. Decisions about a lease's structure that affect its classification as an operating versus a finance lease will affect the ROU asset, lease liability and equity balances recorded in future years, which in turn affects balance sheet-driven ratios. For operating leases, this means the pricing implications of option periods versus longer terms may be evaluated for the balance sheet impact as well as current PE criteria.

Because all leases will result in the recognition of an asset and a liability, the importance of finance versus operating leases likely will decrease in future negotiations. This is true for sale-leaseback transactions currently structured as operating leases. As focus on keeping the lease off the books decreases, focus on the broader economics of lease versus buy decisions is expected to increase. PE firms likely will transition to a more holistic view of whether a lease obligation should be renewed, restructured for more favorable terms and conditions or sold off—a synergy that may result, at least in part, from consolidating vendors.

Debt agreements may include provisions to ensure the increased liabilities will not adversely affect borrowers, *e.g.*, a provision to base debt covenants on GAAP at the time of the loan agreement—otherwise known as "frozen GAAP." Borrowers may want to negotiate for "frozen GAAP" with forthcoming renewals in their conversations with creditors and may want to consider the involvement of legal counsel to review contract terms.

Under the new leases standard, investors in the retail space may have increased opportunity to strategically structure the best economic lease terms to obtain acceptable occupancy costs as well as investment yields and cap rates. PE investors may find it necessary to alter their lease-term risk criterion.

Many firms will want to review their lease-versus-buy decision model as well as their capital expenditures budget versus operating expenditures budget. Treasury will be interested in debt covenants, and procurement will need to understand the new strategies. From a compliance perspective, the lease standard is less prescriptive and more judgment will be required. To comply with the new leases standard, PE firms may need to capture more lease data points in comparison to those required for the extant footnote disclosures. This may require information technology enhancements.

Because lease obligations have typically been the largest off-balance sheet liability, lessee firms will want to get the financial effect of recording them right, and all PE firms will want to get the benefit of strategically approaching leasing activities. Real estate negotiations, in particular, increasingly may be seen as a strategic function driving PE firms' success. Because of this, many PE firms will need to allow for additional time and effort to decide whether and how to renew leases, assess the various implications and achieve the desired results.

Effective Date & Transition

Calendar year-end public business entities, as well as certain not-for-profit entities and employee benefit plans that file financial statements with the U.S. Securities and Exchange Commission (SEC), are required to adopt the leases standard on January 1, 2019. All other entities have an additional year to comply with the new standard. Early adoption is available to all entities.

Entities are required to adopt the new standard using a modified retrospective transition approach, which means they will need to apply the standard as of the beginning of the earliest period presented in their financial statements.

The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. An entity that elects to apply the practical expedients will, in effect, classify and continue to account for leases that start before the effective date in accordance with existing U.S. GAAP, except that lessees will be required to recognize an ROU asset and lease liability on their balance sheet for all operating leases at each reporting date.

BKD will continue to follow lease implementation issues and bring you updates as developments occur. Refer to **BKD Thoughtware®** on Leases for additional information.

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