FASB and PCAOB Proceed with Amendments to Accounting and Auditing Standards

In recent months, the Financial Accounting Standards Board (the "FASB") paved the way for new lease accounting guidance and the Public Company Accounting Oversight Board (the "PCAOB") adopted new rules to enhance disclosure about who is participating in public company audits. Compliance will not be required until the rules take effect, but affected organizations may benefit by beginning to weigh the potential impact of the forthcoming amendments and identifying any changes in internal controls that may be needed to ensure a successful transition.

I. FASB Set to Reshape Treatment of Operating Leases under U.S. GAAP

In a November 2015 meeting, the FASB agreed to finalize and publish its proposed amendments of the lease accounting standards.[1] The new rules, first introduced in a 2009 discussion paper, will require lessees to recognize all leases with a term exceeding one year on their balance sheets.[2] This long-anticipated move will transform the way certain leases are accounted for and reported—right now, operating leases are not recorded on the balance sheet—as part of a joint effort undertaken by the FASB and the International Accounting Standards Board (the "IASB") to improve transparency into the long-term commitments of lessees.[3] Companies and other organizations relying on operating leases to finance operations, particularly those with extensive property lease portfolios, might experience a sharp and potentially material increase in reported assets and liabilities once the changes are implemented.

A. *The Current Lease Accounting Standards*

Current U.S. GAAP follows a bifurcated approach where accounting treatment depends on whether the given arrangement is classified as a capital lease or an operating lease.[4] A capital lease (for example, the lease of a vessel by a cruise line for 30 years) is considered to share the economic characteristics of ownership, in that the lessee is expected to consume a significant part of the asset's estimated value over the term of the lease agreement. Because this arrangement is more akin to a financed acquisition than a temporary hire, a capital lease is accounted for in a manner similar to a purchased asset, with the lessee recognizing an asset and a corresponding lease obligation (typically at the present value of the required lease payments) on its statement of financial position.[5] In contrast, an operating lease (for example, a 10-year lease of office space) is a relatively short-term arrangement that does not span the economic useful life of the underlying asset or transfer to the lessee

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[1] *See FASB Votes to Proceed with Final Standard on Leases* (2015), http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176167530388 ("2015 News Release").

[2] *See FASB In Focus: Proposed Accounting Standards Update on Leases* (2013), available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175826944460&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs ("FASB In Focus"). The proposed requirements will supersede those contained in Topic 840, Leases, of the FASB Accounting Standards Codification. *Id*.

[3] *See id*. and Michael Rapoport, *Coming to a Balance Sheet Near You: $2 Trillion in Leases*, Wall St. J. (Nov. 10, 2015), http://www.wsj.com/articles/leases-to-put-new-weight-on-corporate-balance-sheets-1447200831 ("Rapoport"). The FASB conducted an intensive review and comment process in the time since publication of its initial discussion paper, during which it issued two exposure drafts (in 2010 and 2013), received upwards of 1,740 comment letters, held more than 200 meetings with preparers and end-users of financial statements and participated in numerous roundtables and workshops with practitioners and other interested parties. 2015 News Release.

[4] *See FAQs: Joint FASB-IASB Leases Project* (2013), http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176162614107 ("FASB FAQs").

[5] *Id*.

substantially all the risks and rewards incidental to ownership. This kind of lease is consequently treated on par with a genuine rental contract, for which no asset and no liability are recognized on the lessee's books under the existing accounting system.[6]

This "all-or-nothing" approach to balance sheet recognition has been met with criticism for various reasons. A distorted incentive to configure lease transactions as operating leases—solely to achieve a desired accounting result—is one.[7] Another is the lack of transparency that exists when material lease obligations are kept off the balance sheet.[8] While sophisticated users of financial statements are in many cases able to construct models (supported by the annual operating lease expense and disclosures in the footnotes to the financial statements about the undiscounted amount of operating lease commitments) to assess the magnitude of assets and liabilities arising from off-balance sheet leasing activities, the FASB has expressed concerns about the reliability of these adjustments and the comparability of the resulting estimates.[9] Moreover, economically similar lease transactions are often treated differently under the existing accounting standards, while transactions that are economically distinct regularly receive analogous treatment.[10] These criticisms, alongside a report on off-balance sheet financings in which the SEC staff urged standard-setters to revisit the accounting of leases,[11] were factors that prompted the FASB to recast its current guidance, with the aim of giving all investors "a complete and understandable picture" of lease liabilities upon which to base investment decisions.[12]

B. How the New Approach Differs

The new lease accounting standards will require balance sheet recognition for all leases having a maximum possible term of longer than one year.[13] This, the FASB believes, will better reflect the economics of

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6 *Id*.

7 *See Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (2005), at 63, available at https://www.sec.gov/news/studies/soxoffbalancerpt.pdf ("SEC Staff Report"). The bright-line nature of the current lease accounting guidance renders it susceptible to misuse. *See id*. Indeed, companies may seek to artificially improve performance under financial metrics derived from line items on the balance sheet (such as the return on assets and debt-to-equity ratios) by structuring their lease arrangements as operating leases. Doing so omits the associated assets and liabilities from the relevant calculation, which, in the case of return on assets, for instance, gives the impression that the firm is better able to allocate its resources efficiently and convert its invested capital into profit.

8 *See IASB and FASB Launch Public Consultation on a Future Standard on Lease Accounting* (2009), http://www.fasb.org/news/nr031909.shtml&pf=true. Operating leases comprise a sizeable tranche of existing leases, estimated to have reached a volume of approximately $2 trillion. *See, e.g.*, Rapoport. The FASB believes that failing to fully recognize these debt-like obligations on the balance sheet paints a misleading picture of the total contractual commitments of an organization. *See* FASB In Focus.

9 *See* FASB In Focus and *IASB and FASB Propose Changes to Lease Accounting* (2013), http://www.fasb.org/cs/ContentServer?pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176162614474 ("2013 News Release"). Echoing this sentiment, IASB Chairman Hans Hoogervorst has emphasized that, under the existing framework, "investors must take an educated guess to determine the hidden leverage from leasing by using basic disclosures in financial statements and applying arbitrary multiples." 2013 News Release. He added: "It is clearly not in the best interests of investors to expect analysts and others to guess the liabilities associated with leases." *Id*.

10 *See* SEC Staff Report, at 63 ("[M]ost would agree that there is a significant economic difference between a one-month lease of a building and a 10-year lease of that building. However, if both leases qualified for operating lease treatment, they would likely both have little to no effect on the balance sheet.").

11 *See* FASB FAQs.

12 FASB Project Update, *Leases—Joint Project of the FASB and the IASB* (2015), http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011123.

13 *Id*.

lease transactions while providing a more faithful snapshot of the financial position of the lessee, including its leverage and the cash outflows committed in future periods.[14]

In determining the appropriate method for recognizing, measuring and presenting the assets and liabilities arising from qualifying leases, the FASB has retained a dual approach that, like the existing scheme, focuses principally on whether a lease is effectively an installment purchase of the underlying asset by the lessee.[15]

1. Type A Leases

The first category includes arrangements where the lessee is expected to consume more than an insignificant share of the economic benefits embedded in the leased asset.[16] This will encompass most leases of assets other than land or a building (e.g., aircraft, equipment, vehicles) that qualify for capital lease treatment under the existing rules.[17] Type A leases will be accounted for in a manner similar to capital leases under existing U.S. GAAP.[18] On its balance sheet, a lessee will record both an asset and a liability at an amount initially equal to the present value of the scheduled lease payments during the lease term.[19] Interest paid on the lease liability should be recognized and presented separately from the amortization of the underlying asset.[20]

2. Type B Leases

All other leases, including most that are currently classified as operating leases, fall within the second classification. Because the criticisms described above are attributable in large part to shortcomings in the existing accounting treatment of operating leases, the FASB has decided on the following modifications in the presentation of this class of leases. Rather than remaining off the balance sheet, the rights and obligations inherent in Type B lease contracts should be recorded as follows:

- first, the lessee recognizes a right-of-use asset and a related lease liability on the face of the balance sheet, both of which should initially be measured at the present value of the scheduled lease payments; and

- subsequently, the lessee recognizes a single lease cost, reflecting both the interest on the lease liability and the amortization of the right-of-use asset, on a straight-line basis.[21]

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[14] *See* 2015 News Release and FASB FAQs. Coupled with the change in financial reporting is also an updated set of disclosure standards pertaining to lessees, designed to enable investors to understand the "amount, timing and uncertainty" of the financial receivables and payables associated with leases. Financial Accounting Standards Board, *Leasing—Core Principles*, http://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1351027207574#section_3 ("FASB Project Overview").

[15] *See* FASB FAQs.

[16] *See id*. and FASB Project Overview.

[17] Proposed Accounting Standards Update (Revised), *Leases (Topic 842)—a revision of the 2010 proposed FASB Accounting Standards Update, Leases (Topic 840)* (2013), at 35, available at http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176162613656&acceptedDisclaimer=true.

[18] *Id*. at 53. *See also* FASB Project Overview under the heading entitled "How Will the New Standard Change Current GAAP?"

[19] *See* FASB Project Overview.

[20] *Id*.

[21] *Id*.

C. Transition and Effectiveness

The FASB is expected to publish the final accounting standards update on leases in early 2016. It will be effective for the annual and interim periods beginning after December 15, 2018, for public companies, and December 15, 2019, for private companies. However, the final standards will require retrospective application for certain comparative periods presented in the financial statements. Early adoption will be permitted upon issuance.[22]

II. PCAOB Pursues Improvements in Auditor Transparency and Accountability

Last month, the PCAOB adopted new rules and amendments that, subject to SEC approval, will require audit firms to make certain information about the audit team available to investors.[23] Under the revised auditing standards, accounting firms will be required to complete and file a new PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, for each audit of a public company, identifying:

(1) the name of the engagement partner;

(2) the name, location and extent of participation of each other accounting firm whose assistance in the audit constituted at least 5% of total audit hours; and

(3) the number and aggregate extent of participation of all other accounting firms taking part in the audit but whose individual contribution amounted to less than 5% of total audit hours.[24]

The Form AP must be filed 35 days (or, in the case of initial public offerings, 10 days) after the date the applicable auditor's report is first included in a document filed with the SEC.[25]

James R. Doty, the PCAOB Chairman, observed that adding this disclosure to the mix of information available to investors "should further incentivize auditors to organize audit teams conscientiously to give investors comfort that it is reliable."[26]

If approved by the SEC, disclosure of the identity of the engagement partner will be required for auditor's reports issued on or after January 31, 2017 or, if later, three months after such approval is obtained. The disclosure requirements relating to other participating audit firms will be effective for reports issued on or after June 30, 2017.[27] The PCAOB staff intends to issue guidance later in the year to assist firms in complying with the new reporting requirements.

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22 2015 News Release.

23 *See* PCAOB Release No. 2015-008, *Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards* (2015), available at http://pcaobus.org/Rules/Rulemaking/Docket029/Release-2015-008.pdf.

24 *Id*. at 1.

25 PCAOB Adopts Rules Requiring Disclosure of the Engagement Partner and Other Accounting Firms Participating in an Audit (2015), http://pcaobus.org/News/Releases/Pages/PCAOB-adopts-disclosure-rules-Form-AP-12-15-15.aspx. Information filed on the Form AP will be accessible by the public via a searchable database on the PCAOB's website. *Id*.

26 *Id*.

27 *Id*.

III. Conclusion

Lessees and accounting firms should familiarize themselves with the requirements imposed by the new lease accounting and audit transparency standards. Companies that currently hold assets under operating lease agreements should conduct a detailed review of the revised FASB lease accounting model and consider whether new systems or controls are necessary to adequately track the required information on existing and future leases.

The expected change in balance sheet metrics has raised concerns about the ability of affected companies to comply with covenants in loan agreements, bond indentures and other agreements. While operating obligations may be excluded from the definition of "indebtedness" and/or the interpretation of U.S. GAAP may be contractually frozen in time, companies should consider whether they will remain compliant with applicable loan and other covenants under the new lease accounting rules.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Tyler A. O'Reilly at +44.20.7920.9819 or toreilly@cahill.com.