Applying the New Leasing Standard

A Q&A with Equity Methods and the Franklin Nova Group

The implementation of ASC 842, the new accounting standards governing leases, is hitting companies right now. What are the key steps and how can companies carry them out? Industry experts from Franklin Nova and Equity Methods share their observations.

What's the new leasing standard in a nutshell?

BRIAN SARKIS, *managing director, Franklin Nova*: The core principle is that all assets and liabilities arising from leases must now be recorded on the balance sheet at fair value. This differs from the past, where most leases were actually not recorded on the balance sheet. Since most companies have leases, all companies are going to need to do a lot of work breaking out and valuing all of their leases. This ranges from those with just a headquarters lease or a corporate van to those whose business model depends on leases—retailers, manufacturers, or sales organizations with multiple sales offices.

What's the timeline?

BRIAN: The standard was adopted in February 2016, so there was some runway. But as with any new standard (just look at revenue recognition), it takes a while to work out the bugs and figure out what to do. It's effective for public companies' annual periods beginning December 15, 2018, so calendar-year companies will need to start using the standard in January. Private companies get an extra year, so they can relax for now.

Early adoption was permitted, but very few companies took this standard on early.

In your experience, what key issues do companies face?

BRIAN: Well, first companies need to understand what leases they have. This has been a big source of frustration for companies. For example, many apparent service arrangements (such as contract manufacturing, logistics services, and outsourced warehousing) are all leases under ASC 842. As such, companies should plan on seeing their lease population grow under the new standard.

The next problem is many companies have not taken the time to document all of the terms of their leases. Critical items such as term, lease rates, and even a listing of the subject items aren't centralized, and all of this information must be known before starting the process.

JOSH SCHAEFFER, PhD, *director, Equity Methods:* Of course, that's just the first part of the problem. Once you identify all the leases, you need to value them all. The key component here is the discount rate to apply to the cash flows. But discount rates aren't necessarily easy to isolate because companies face an array of different discount rates on different assets and liabilities, and this new standard requires one for a loan secured by an asset.

Can we talk a little about what you mean by "secured by an asset"?

JOSH: Yes, understanding different interest rates is crucial here. I think an analogy to personal finance is very helpful as well.

The highest rate debt out there is unsecured debt. This is where the company has made a promise to pay, however, there is no legal ability to claim any of the company's assets as repayment. Picture a credit card. If you stop paying, the card company can call you, appeal to your sense of fairness, send to collections, and harm your credit. But at the end of the day, if you never pay, they won't be able to take your property without your consent. And if you go bankrupt, they likely end up with nothing.

Then there's secured debt. In the general case, secured debt has a senior claim on all the assets of the corporation. This means that debtholders can recover losses by accepting (or, more typically, forcing the sale of) a company's underlying assets. Tax losses are an example of this kind of secured debt. If you don't pay, the IRS can seize your assets or garnish your wages. Further, after bankruptcy, they can still get paid.

The important kind of debt for the leasing standard is secured—or collateralized—by a specific asset. Asset-backed secured debt has a specific claim on a specific underlying "thing" or collateral. For example, your car loan and mortgage are asset-backed loans. If you fail to make car payments, the bank can repossess the car, but cannot garnish your wages. In this case, the lender—assuming the lender has acted responsibly and not lent more than the value of the car, and the car was not damaged—would be able to seize the asset and sell it. So, ultimately, the lender has limited risk of loss related to the collateral.[1]

BRIAN: It's great to think about loans in that simpler framework. Of course, we also need to realize that with corporate bankruptcy, it's quite a bit thornier. There's a lot of negotiation, and only in rarer Chapter 7 bankruptcies is everything liquidated and sold. Most of the time, the companies reorganize and everyone gets some piece of the new company.

What's the preferred discount rate to apply?

BRIAN: The rate implicit in the specific lease is the preferred option. However, it's extremely difficult to determine this rate as it's uncommon for the lessor to share the information required to calculate the implied lease rates. Even if this is available for one lease, it may not be applicable to the portfolio given that there are many factors which affect the lease rate. As a result, most companies we've spoken to find it more practical to apply the incremental borrowing rate option as outlined in the new standard.

JOSH: The car lease is a perfect example. There, whether or not the customer realizes it, everyone agreed on the price of the car, the residual value, and the payments. Therefore the lease rate is easy to determine. Unfortunately that doesn't happen in corporate leases very often, and lessors won't open up the books on their models.

How do companies estimate their incremental borrowing rate?

BRIAN: Every company is different. Some have publicly-traded debt, others do not. For companies with public debt, the starting point is their own debt rating, which is used to develop an appropriate unsecured interest rate curve and then adjusted to arrive at a securitized interest rate curve. Companies without published debt ratings must create one to establish the appropriate borrowing rates specific to the company. For companies with no existing debt, some models might come up with answers that are inconsistent with what a company would see if they actually looked to borrow money.

JOSH: We've seen a lot of work trying to adjust rates to determine an incremental borrowing rate. One way to do this bifurcates an interest rate into two portions, a risk-free rate—basically

[1] If you owe more on the car than the value, this gap reflects an unsecured debt to the noteholder. Insurers sell gap insurance that covers this in case your car is damaged and no longer worth anything.

what the U.S. government would pay—and an adjustment for the fact you may lose money. The adjustment for losing money further considers both the probability the company fails and the amount the lender would lose.

Of course, collateral doesn't change the probability, but you lose less in case of default. By changing that probability, we can back into a new rate. Now there are a few wrinkles with that approach. But typically, it can compute the incremental borrowing rate, which is also updateable through time.

Is there any advice for companies doing their first calculation?

BRIAN: Focus on completeness! Therefore, make sure that you've identified and summarized all the leases. Key pieces to know are the rates, terms, and—don't forget—what you've actually leased.

JOSH: For the debt side, take measure of the debts your company has. Are they secured, unsecured, or asset-backed? Which ones are most and least senior? If any debt is publicly traded, is there a market with interest rates available to the company? If not, were debts recently issued, or will you need to consider whether market factors and rates have changed?

Even if your company doesn't have debt, there may be an indicative rate from a bank or perhaps a credit rating.

BRIAN: If all else fails, there are models to estimate a company's credit rating and borrowing rate based on their financials.

Once the company adopts a standard and determines rates, what are the next steps?

BRIAN: As more companies adopt the standard, I expect the process of updating the incremental borrowing rates and maintaining an inventory of leases will become more streamlined. However, the company's incremental borrowing rate frequently changes as its business, economic conditions, and markets change. Therefore, lease accounting will not be a one-time problem.

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About the Franklin Nova Group

The Franklin Nova Group is a boutique valuation firm compromised of professionals that have built their careers at world-class firms. We are able to offer our expertise and experience at competitive rates by eliminating overhead, streamlining our work process, and embracing technology. Our firm is structured to only employ experienced professionals who are singularly focused on meeting our clients' needs in a timely and informed manner.

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