New FASB Rules on Accounting for Leases: A Sarbanes-Oxley Promise Delivered

*By Donald J. Weidner**

Congress responded to the first financial accounting scandals of the new millennium by enacting the Sarbanes-Oxley Act of 2002, which required the Securities and Exchange Commission ("SEC") to study issuers' filings and report on whether their financial statements reflect the economics of off-balance sheet arrangements to investors in a transparent fashion. In 2005, the SEC reported that there "may be approximately $1.25 trillion in non-cancellable future cash obligations committed under operating leases that are not recognized on issuer balance sheets, but are instead disclosed in the notes to the financial statements." Accordingly, the SEC requested that the Financial Accounting Standards Board ("FASB") craft new rules to record more lessee liabilities on the balance sheet.

In 2016, the FASB issued sweeping new rules that affect virtually every firm that leases assets "such as real estate, airplanes, and manufacturing equipment." In a dramatic change in approach, every lease extending more than twelve months will be capitalized and recorded on the lessee's balance sheet as reflecting both a "right-of-use asset" and a corresponding liability. The new rules move away from the formalism of bright-line rules and toward an affirmative obligation to record economic substance. This article provides an overview of the history, policy, and mechanics of the new rules, which are likely to have a significant economic impact on many companies.

I. Introduction

A lease can be defined as a contractual obligation that allows an asset owned by one person to be used by another over a period of time in exchange for consideration. Leases can be long or short, for one payment or multiple payments, and for fixed or varying payments. They can cover any type of tangible asset, from computers and airplanes to land and buildings. They can cover only a small portion of the useful life of the underlying asset, or they can cover most or all of it. They can be entered into for various objectives, including economies of scale, flexibility, the reduction of exposure to the risk of full ownership of the underlying asset, the obtainment of greater access to capital, or tax objectives and accounting advantages.

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The financial accounting scandals that came to light in the early 2000s made clear that to a widespread and systemically significant extent, lessees that were the substantive owners of heavily leveraged properties were keeping both the asset and the liability off their balance sheets.[1] Companies took advantage of the applicable financial accounting standards then in place to keep more than one trillion dollars of liabilities off their balance sheets. The financial accounting standards were more reflective of form than of substance: they treated users as mere tenants with no obligation to record their long-term lease obligations on the balance sheet.[2] In this respect, lease obligations were treated in a similar fashion to other operating expenses, except in those few situations in which leases were required to be capitalized. Current and prior financial accounting standards permitted companies to flunk fairly mechanical tests to disqualify themselves from ownership status. If they were not the substantive owners, their long-term lease obligations needed not be recorded as assets or liabilities on the balance sheet. Accordingly, many very significant, long-term lease obligations were excluded because the leases did not represent substantive ownership. For example, a firm that leases a new building for fifteen years has made a significant long-term commitment but has not been required to record that commitment on its balance sheet.

Part II of this article explains the still-applicable "old" FASB rules that have permitted public companies to keep far in excess of one trillion dollars of long-term lease liabilities off their balance sheets. Part III discusses the SEC report ordered by the Sarbanes-Oxley Act of 2002 to address the phenomenon of off-balance sheet financing. The SEC report found fundamental faults with the old rules and recommended that the FASB craft new rules to record more lessee liabilities on the balance sheet.

Part IV is the core of this article. It analyzes *Accounting Standards Update No. 2016-02*,[3] which the FASB issued in February 2016 in response to the SEC report and other calls for reform. These new rules on lease accounting are exten-

1. Over the centuries, the form of a lease has been used to mask the substance of a financing arrangement. Purported tenants were often the substantive owners of the underlying asset. For example, sale leasebacks were used to avoid various religious proscriptions against charging either interest or excessive interest. Rather than lending money to an owner of an asset and charging a prohibited interest, the provider of funds or credit would avoid the label "lender" and instead purchase the asset from the owner seeking financing and contemporaneously lease it back to that person. The "rent" would provide the "landlord" with a return of investment plus profit and leave the tenant in possession. Alternatively, a seller on credit would simply lease an asset to the would-be purchaser. *See generally* Donald J. Weidner, *Synthetic Leases: Structured Finance, Financial Accounting and Tax Ownership*, 25 J. Corp. L. 445 (2000) [hereinafter Weidner].

2. Many of these same firms successfully claimed they were the substantive owners and borrowers for purposes of the federal income tax law. It is common and perfectly appropriate for companies to have two very different sets of books: one for financial accounting purposes and another for federal income tax purposes. Taxpayers are permitted to take tax reporting positions that differ from their financial accounting positions. *See* Frank Lyon Co. v. United States, 435 U.S. 561, 577 (1978) ("[T]he characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same."); *see also* Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542 (1971) (referring to "the vastly different objectives that financial and tax accounting have").

3. Fin. Accounting Standards Bd., Accounting Standards Update No. 2016-02, Leases (Topic 842) (Feb. 2016) [hereinafter ASU 2016-02], *adding* Accounting Standards Codification 842 [hereinafter ASC 842].

sive and represent a major change in approach. They will have widespread implications throughout the economy. The purpose of this article is to analyze the core concepts in the new rules and explain how they differ from the old rules. In short, the new rules require most business leases for more than a year to be recorded on the lessee's balance sheet as reflecting both an asset and a liability. For income statement purposes, the rules continue a modified version of the distinction between operating leases and finance leases. Part IV concludes by considering the effective date, transition rules, and major impacts of ASU 2016-02. Part V offers a few final conclusions.

II. The "Old" FASB Approach to Balance Sheet Recording

The still-applicable old rule that has allowed many lease obligations to be kept off balance sheets is Statement of Financial Accounting Standards No. 13, which was first issued in 1976.[4] It says that unless a lease is a "capital" lease, it need not appear on the lessee's balance sheet. It is a capital lease only if, under very specific rules, it transfers substantially all the benefits and burdens of ownership to the lessee. It defines a "lease" as "an agreement conveying the right to use property, plant or equipment . . . usually for a stated period of time."[5] Thus, SFAS 13 applies to agreements that may not even be "nominally identified as leases."[6] The old approach of SFAS 13 continues in effect until the new rules are effective, either in 2019 or 2020, depending on the nature of the firm.[7]

A. Four Tests to Distinguish a "Capital" from an "Operating" Lease

To be an off-balance sheet arrangement under SFAS 13, the lease must be classified as an operating lease rather than as a capital lease.[8] SFAS 13 states that a lease is a capital lease if it meets any one of four criteria. If none of those criteria is met, the lease is treated as an operating lease.[9]

A lease is classified as a capital lease if it meets one or more of the following criteria:

(a) the lease transfers ownership of the property to the lessee by the end of the lease term;

(b) the lease contains a bargain purchase option to purchase the leased property;

4. See Fin. Accounting Standards Bd., Statement of Financial Accounting Standards No. 13, Accounting for Leases (Nov. 1976) [hereinafter SFAS 13].

5. *Id.* at para. 1.

6. Fin. Accounting Standards Bd., Emerging Issues Task Force Issue No. 01-8: Determining Whether an Arrangement Contains a Lease at para. 7 (May 2003).

7. The precise effective date of the new rules depends on whether the company is public or private. *See infra* Part IV.

8. *See* SFAS 13, *supra* note 4, at para. 7.

9. *Id.*

(c) the lease term is equal to 75 percent or more of the estimated economic life of the leased property; or

(d) the present value, at the beginning of the lease term, of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property to the lessor at the inception of the lease.[10]

Stated differently, if a lease passes any one of these four tests, the lessee will be required to record it as a capital lease on its balance sheet.

B. Consequences of a Capital Lease

Treating the lease as a capital lease means several things. First, the lessee records the capital lease as an asset and as an obligation at an amount equal to the present value, at the beginning of the lease term, of the minimum payments over the lease term.[11] If both land and buildings are involved, they must be separately capitalized in proportion to their fair values at the inception of the lease.[12] Second, any capitalized building asset must be amortized.[13] Third, each minimum lease payment must be allocated between a reduction of obligation and interest payment.[14] Finally, "a termination of a capital lease must be accounted for by removing the asset and obligation" and recognizing gain or loss for the difference.[15] However, if a lease has none of the four characteristics of a capital lease, it is treated as an operating lease.[16]

C. Consequences of an Operating Lease

If a lease is an operating lease, the asset is not recorded on the lessor's balance sheet,[17] and the lessee ordinarily records rent expense over the lease term only as it becomes payable. The lessee is not required to record either an asset or a long-term liability on the balance sheet proper. However, the lessee must disclose, at least in a note to the financial statements, certain minimum future lease payments.[18] In addition, if the lessee is a public company, it may be required to make disclosures regarding both capital and operating lease obligations in management disclosures.[19]

10. *Id.*
11. *Id.* at para. 10.
12. *Id.* at para. 26.
13. *Id.* at para. 11.
14. *Id.* at para. 12.
15. *Id.* at para. 14(c).
16. If the lease is from a special purpose entity ("SPE") affiliated with the lessee, the lessee and the SPE may be required to prepare a consolidated financial statement, thus indirectly recording the lease on the lessee's balance sheet. *See* Weidner, *supra* note 1, at 458–62.
17. SFAS 13, *supra* note 4, at para. 19(a).
18. *Id.* at para. 16(b).
19. U.S. Sec. & Exch. Comm'n, 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 62 (July 2003) [hereinafter SEC Report], https://www.sec.gov/news/studies/soxoffbalancerpt.pdf.

D. Core Concept: Capitalize Only If You Own Underlying Asset

At its core, SFAS 13 requires balance sheet recognition only if an "ownership" model is satisfied. The four criteria of SFAS 13 are said to be derived from the concept that a lease must be capitalized only if it transfers substantially all the benefits and risks of ownership to the tenant, even if it is not equivalent in substance to a purchase:

> [A] lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor. All other leases should be accounted for as operating leases. In a lease that transfers substantially all of the benefits and risks of ownership, the economic effect on the parties is similar, in many respects, to that of an installment purchase. This is not to say, however, that such transactions are necessarily "in substance purchases" as that term is used in previous authoritative literature.[20]

The drafters of SFAS 13 thought that its principal contribution was to extend the "substantially all of the benefits and risks" analysis to lessees and thereby require certain lessees to report according to the same principles that are applied to lessors.[21]

The drafters probably never anticipated the extent to which companies would structure lease obligations specifically to flunk all four of the SFAS 13 tests for lease capitalization and thereby avoid recording lease liabilities on the balance sheet. Companies wanted lease obligations to be treated more like ordinary operating expenses, which are not included on the obligor's balance sheet. For example, obligations to compensate employees are generally not on the balance sheet, even if the employees are under long-term contracts. As the SEC would report decades later, "lease structuring to meet various accounting, tax, and other goals" became "an industry unto itself in the last 30 years."[22]

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20. SFAS 13, *supra* note 4, at para. 60.

21. *Id.* at para. 61 ("The transfer of substantially all the benefits and risks of ownership is the concept embodied in previous practice in lessors' accounting. . . . However, a different concept has existed in the authoritative literature for lessees' accounting. . . . [Earlier authority] required capitalization of those leases that are 'clearly in substance installment purchases of property,' which it essentially defined as those leases whose terms 'result in the creation of a material equity in the property.' Because of this divergence in both concept and criteria, a particular leasing transaction might be recorded as a sale or as a financing by the lessor and as an operating lease by the lessee."). The FASB explained its reason for rejecting the argument that the only leases that should be capitalized are those that are in substance installment purchases: "Taken literally, the concept would apply only to those leases that automatically transfer ownership. All other leases contain characteristics not found in installment purchases, such as the reversion of the property to the lessor at the termination of the lease." *Id.* at para. 69.

22. SEC Report, *supra* note 19, at 63.

III. Sarbanes-Oxley and the SEC Report

A. The Sarbanes-Oxley Act

A number of financial accounting scandals boiled to the surface in 2001 and 2002, including those involving Enron and WorldCom. Reflecting a sentiment that the rules relating to financial reporting and the entire audit function needed to be improved, Congress responded by enacting the Sarbanes-Oxley Act of 2002 ("SOX").[23] Also referred to as the Public Company Accounting Reform and Investor Protection Act in the Senate and as the Corporate and Auditing Accountability and Responsibility Act in the House, SOX introduced a broad array of reforms to the financial reporting system in the United States. Among other things, SOX created the Public Company Accounting Oversight Board to increase the oversight of auditors of public companies.[24] It also required key corporate officers to provide periodic certifications regarding a company's disclosure controls and procedures, internal control over financial reporting, and certain other matters.[25]

Section 401(c)(1) of SOX required the SEC to conduct a study of filings by issuers and to issue a report addressing two primary questions: (1) the extent of off-balance sheet arrangements, including leases and the use of SPEs; and (2) whether generally accepted accounting rules result in financial statements that reflect "the economics of such off-balance sheet transactions to investors in a transparent fashion."[26]

B. The SEC Report

1. Magnitude of the Problem and Call for Reform

The SEC Report, released on June 15, 2005, is the result of an empirical study of filings by 200 issuers and a qualitative review of generally accepted financial accounting standards in the United States. The SEC Report concluded that there "may be approximately $1.25 trillion in non-cancellable future cash obligations committed under operating leases that are not recognized on issuer balance sheets, but are instead disclosed in the notes to the financial statements."[27] Accordingly, the SEC Report recommended that the accounting guidance for leases be reconsidered.[28]

23. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of the U.S.C.).

24. *Id.* § 201, 15 U.S.C. § 78j (2012) (directing the SEC to establish rules prohibiting auditors from providing certain nonaudit services to audit clients).

25. *Id.* §§ 901–906, 18 U.S.C. §§ 1341, 1343, 1349, 1350, & 29 U.S.C. § 1131 (2012).

26. *Id.* § 401(c)(1)(B).

27. SEC Report, *supra* note 19, at 4. The $1.25 trillion does not include amounts attributed to non-SEC registrants.

28. *Id.*

2. Critique of SFAS 13

The SEC Report's basic critique of SFAS 13 related to its all-or-nothing treatment of leases. Despite the tremendous diversity in leasing arrangements, "all leases receive one of two opposing accounting treatments; either the lease is treated as if it were a sale or as if it were a rental."[29] If most of the risks and rewards of ownership are transferred to a lessee, the lease is treated as a sale of the entire asset by the lessor and as a purchase of an asset financed with debt by the tenant. Stated differently, if the lease is a capital lease, the whole of the asset is treated as sold.[30] The lessee records on its balance sheet both the asset and the related liability at the present value of the required lease payments.[31] If instead the lease does not meet any of the four SFAS 13 tests to be a capital lease, it is classified as an operating lease and treated as a rental contract. The lessee does not record either an asset or a related liability on its balance sheet, "but records leasing expense in its income statement, also on a period-by-period basis."[32]

The SEC Report was not precisely correct when it stated that the "intention" of SFAS 13 "is to treat those leases that are economically equivalent to sales as sales, and to treat other leases similar to service contracts." As explained above, the stated intention was slightly different. The core concept of SFAS 13 is to treat a transfer of "substantially all" of the benefits and burdens of ownership as a sale, even if it does not rise to the level of a true sale.[33] Nevertheless, the basic point of the SEC Report is correct: the current approach "does not allow the balance sheet to show the fact that, in just about every lease, both parties have some interest in the asset, as well as some interest in one or more financial receivables or payables."[34]

The SEC Report correctly concluded that the all-or-nothing result of passing or failing the bright-line tests of SFAS 13 means that "economically similar arrangements" may receive different accounting treatment—if they are just to one side or the other of the bright line.[35] It is easy to see that a lease that commits a lessee to pay 89 percent of an asset's value is not very different from a lease that commits a lessee to pay 90 percent of the asset's value. Nevertheless, the treat-

29. *Id.* at 60.

30. *Id.*

31. *Id.* Conversely, the lessor removes the cost of the asset from its balance sheet and reports its sale for an amount "equal to the present value of the required lease payments, plus the expected remaining value of the leased asset at the end of the term." *Id.*

32. *Id.* at 61. The lessor keeps the asset on its balance sheet and records rental income in its income statements as well as depreciation.

33. *See* SFAS 13, *supra* note 4, at paras. 61, 69. Indeed, at the time SFAS 13 was promulgated, some members of the FASB held

> the view that, regardless of whether substantially all the benefits and risks of ownership are transferred, a lease, in transferring for its term the right to use property, gives rise to the acquisition of an asset and the incurrence of an obligation by the lessee which should be reflected in his financial statements.

Id. at para. 63. This is, of course, the view that ultimately carried the day in ASU 2016-02.

34. SEC Report, *supra* note 19, at 62.

35. *Id.*

ment of the two is dramatically different because only the latter lease passes one of the four SFAS 13 tests for a capital lease, and so only the latter lessee must record the long-term liability and the corresponding asset on its balance sheet. Conversely, the SEC Report was also concerned that under SFAS 13, "economically different transactions may be treated similarly."[36] It noted that despite the "different economic significance," both a one-month lease and a ten-year lease of a building have "little to no balance sheet impact" if they are both classified as operating leases. It acknowledged, however, that the "extensive disclosures for leases do provide some information about the rights and obligations inherent in operating leases."[37]

Finally, the SEC Report noted that although SFAS 13 may have been an effective innovation when it was first introduced,[38] its bright-line rules have been gamed to a startling degree:

> [M]any issuers involved in leases, taking advantage of the bright-line nature of the lease classification guidance, structure their lease arrangements to achieve whatever accounting (sales-type/capital or operating) is desired. These issuers have been aided in these endeavors by a large number of attorneys, lenders, investment banks, accountants, insurers, industry advocates, and other advisors. Indeed, lease structuring to meet various accounting, tax, and other goals has become an industry unto itself in the last 30 years.[39]

3. Recommendation of New Rules on Leases

The focus of the SEC Report "is on the standards themselves and recommendations tend to focus on what changes the FASB, as the accounting standard-setter in the U.S., should consider."[40] Most fundamentally, the SEC Report recommended that the FASB reconsider the "all or nothing" approach of SFAS 13:

> The current "all or nothing" lease accounting guidance is not designed to reflect the wide continuum of lease arrangements that are used, and therefore, it cannot transparently and consistently reflect the varying economics of the underlying arrangements.[41]

In addition, the SEC Report cautioned against bright-line rules that invite gaming to treat similar arrangements quite differently.[42] Finally, the SEC Report recommended that the FASB reconsider lease accounting rules that focus on contractual cash inflows and outflows to determine the amount of assets and liabilities to record on balance sheets.[43] Lease accounting based on cash flows "would

36. *Id.* at 63.
37. *Id.*
38. *Id.* ("Indeed, the current accounting guidance, which is criticized by many, would likely be held in much higher regard were it being applied to the lease arrangements that existed when it was debated and created.").
39. *Id.*
40. *Id.* at 3.
41. *Id.* at 105–06.
42. *Id.* at 106.
43. *Id.*

generally require both parties in lease agreements to report their economic interests in the leased assets as well as assets and/or liabilities related to payments mandated by the lease agreement."[44]

The SEC Report acknowledged that it was sending the FASB a project that was highly complex, extremely controversial, and internationally significant. It was complex because of the tremendous variety of leases and lease mechanisms, "including contingent rents, optional extensions, penalty clauses, purchase options and others that each will require consideration."[45] It was controversial because of the widespread practice of lease structuring:

> The fact that lease structuring based on the accounting guidance has become so prevalent will likely mean that there will be strong resistance to significant changes to the leasing guidance, both from preparers who have become accustomed to designing leases that achieve various reporting goals, and from other parties that assist those preparers.[46]

The project was significant internationally both because many foreign investors and creditors rely on the financial statements of U.S. firms and because many foreign firms prepare their financial statements in accordance with FASB standards.

The leasing project was also significant because of the interest, here and abroad, in greater convergence between the U.S. Generally Accepted Accounting Principles ("GAAP") of the FASB and the International Financial Reporting Standards ("IFRS") adopted by the International Accounting Standards Board ("IASB"). The SEC Report noted that the "FASB, as part of a group of standard setters known as the G4+1, has considered, in depth," lease accounting reform measures.[47] Perhaps most broadly, the SEC Report encouraged expanded use of the IASB's "objectives-oriented" or "principles-based" accounting rather than the FASB's more rules-based accounting.[48] Stated differently, the SEC Report encouraged the FASB to move away from the formal structure of transactions and toward judgments about their economic substance. Accordingly, the SEC

44. *Id.* at 106. The SEC Report also noted that "sophisticated users, such as credit-rating agencies, often adjust balance sheets in their work so they can analyze companies as if all leases were reflected on the balance sheet." *Id.*

45. *Id.*

46. *Id.* at 63.

47. *Id.* at 106. Members of the G4+1 included the Australian Accounting Standards Board, the Canadian Accounting Standards Board, the International Accounting Standards Committee, the New Zealand Accounting Standards Review Board, the New Zealand Financial Reporting Standards Board, the United Kingdom Accounting Standards Board, and the FASB.

48. *Id.* at 3 (recommending an expanded "use of objectives-oriented standards, which would have the desirable effect of reducing complexity in accounting methods"). Not everyone has been in favor of the direction the move has taken. *See, e.g.*, Letter of Sen. Carl Levin to Russell G. Golden, Chairman, Fin. Accounting Standards Bd. 4 (Oct. 14, 2014) ("U.S. GAAP has been the gold standard for financial reporting requirements and has contributed to this success [at attracting and fostering foreign investment]. In contrast, the IFRS rely more on principles than requirements, invite multiple interpretations, have been more difficult to enforce, and have been subjected to abusive practices to circumvent effective accounting disclosures. In many instances, IFRS permit less transparency and greater variations in financial reporting than GAAP.").

Report recommended that the FASB proceed jointly with the IASB on the leasing project.[49]

IV. The New FASB Rules: ASU 2016-02

A. Overview of the Joint Project of the FASB and the IASB

Encouraged by the SEC Report and by other critics of the old leasing rules, the FASB and the IASB in 2006 together undertook to formally revise the financial accounting standards for leases. Each group hoped that its new rules would reflect the true economic position an entity enters into when it obtains access to capital in the form of a lease. They sought "to improve and converge" their existing standards to record lease obligations on a firm's balance sheet.[50] As the SEC Report had predicted, the project was both complicated and controversial. The two groups issued a 2009 discussion paper,[51] which was followed by a first exposure draft in 2010. Reactions to the first exposure draft were intense.[52]

As the SEC Report had predicted, there was strong resistance to the significant changes embodied in the first exposure draft. The U.S. Chamber of Commerce ("Chamber"), together with a variety of other private groups primarily from the real estate industry, commissioned a study of the economic impact of the FASB/IASB exposure draft. The study, which was prepared by Chang & Adams Consulting and released in February 2012, predicted dire economic consequences if the exposure draft were adopted:

> The capitalization of operating leases would impact a broad number of financial metrics that are used by investors, causing a number of firms to violate their lending covenants and retarding their ability to acquire new credit. It would force firms to cut their spending. And it would generate losses in real estate value.[53]

49. *Id.* at 106. The FASB and the IASB had already signed the Norwalk Agreement of 2002, in which they committed to develop "high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting." *See* Fin. Accounting Standards Bd. & Int'l Accounting Standards Bd., Memorandum of Understanding: The Norwalk Agreement 1 (2002), http://www.fasb.org/news/memorandum.pdf; *see also* Denise Lugo & Stephen Bouvier, *FASB, IASB Revised Proposals Would Cause Significant Lease Accounting Changes*, Acct. Pol'y & Prac. Rep. (BNA), May 24, 2013, at 420. For a 2008 progress report, see Fin. Accounting Standards Bd., Completing the February 2006 Memorandum of Understanding: A Progress Report and Timetable for Completion (Sept. 2008), http://www.fasb.org/intl/MOU_09-11-08.pdf; *see also Convergence with the International Accounting Standards Board (IASB)*, Fin. Acct. Standards Board, http://www.fasb.org/intl/convergence_iasb.shtml (last visited Jan. 28, 2017).

50. *Accounting and Auditing Oversight: Pending Proposals and Emerging Issues Confronting Regulators, Standard Setters, and the Economy: Hearing Before the Subcomm. on Capital Mkts. & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 112th Cong. 12–13 (2012) (statement of FASB Chair Leslie F. Seidman).

51. Fin. Accounting Standards Bd., Fin. Accounting Series Discussion Paper No. 1680-100, Leases: Preliminary Views (2009), http://www.fasb.org/draft/DP_Leases.pdf.

52. Fin. Accounting Standards Bd., Proposed Accounting Standards Update: Leases (Topic 840), Exposure Draft (2010), http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176162613656&acceptedDisclaimer=true.

53. Chang & Adams Consulting, The Economic Impact of the Current IASB and FASB Exposure Draft on Leases 5 (2012) [hereinafter Chamber Study], http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-02-08-IASB-FASB-CA-Report-FINAL-v-3-_2_.pdf. In addition to the U.S.

The Chamber Study purported to measure three effects: reduced spending necessitated by deleveraging to deal with "apparent increases in liabilities," increased borrowing costs "for lessees with higher debt ratios,"[54] and the reduced valuation in real estate caused by the resulting contraction of the economy.[55] It concluded that the new standard would increase "the apparent liabilities of U.S. publicly traded companies by $1.5 trillion,"[56] with more than two-thirds of that increase attributable to balance sheet recognition of real estate operating leases.[57] Under the Chamber Study's "best case" scenario, the new standard "would destroy approximately 190,000 U.S. jobs" and reduce U.S. gross domestic product ("GDP") by $27.5 billion annually.[58] In addition, "U.S. public companies would face $10.2 billion in annual costs from the increased interest on borrowing" and commercial real estate would lose $0.6 billion in value because of economic contraction.[59]

The FASB's parent organization, the Financial Accounting Foundation ("FAF"), commissioned Professor Robert C. Lipe to review the Chamber Study. In April 2015, he released *Review of the Chang and Adams Leasing Study: Are the Predicted Economic Effects Likely to Occur?*[60] The Lipe Review faulted the assumptions and methodology of the Chamber Study and surveyed academic and business sources to provide "compelling evidence that many lenders and their analysts already include adjustments for the impact of off-balance sheet leases in their lending decisions."[61] These sources also indicated that lenders and other creditors distinguish a change in the balance sheet mandated by new accounting rules from a change in

Chamber of Commerce and the Real Estate Roundtable, the other organizations that joined in commissioning the Chamber Study are listed at its beginning.

54. The most basic measure of a firm's leverage is probably its debt-to-equity ratio. As more debt is recorded on the balance sheet, the ratio increases, indicating greater leverage. This is true even if a corresponding right-of-use asset is recorded in the same amount as the new lease liability. An increase in the debt/equity or other leverage or debt coverage ratios could be an occasion for a lender to increase interest rates when a loan is negotiated or refinanced. It also may trigger a regulatory response or internal control.

55. CHAMBER STUDY, *supra* note 53, at 6. The Chamber Study did not consider any reduction in real estate values that might be caused by shorter leases, nor did it consider increased accounting or administrative costs.

56. *Id.* at 2.

57. *Id.*

58. *Id.*

59. *Id.* In the Chamber Study's "worst case" scenario, "there would be a loss of 3.3 million jobs" and GDP would be lowered by $478.6 billion annually. *Id.* There was an almost immediate and sharply negative response to the Chamber Study from the other side of the debate: "These doomsday predictions border not only on the ridiculous, but also the whimsical." *See, e.g.*, Anthony H. Catanach, Jr. & J. Edward Ketz, Op/Ed, *The Economic Impact of Capitalizing Leases: The Chamber of Commerce Study*, SMARTPROS LEGAL (Mar. 2012), http://accounting.smartpros.com/x73475.xml.

60. ROBERT C. LIPE, REVIEW OF THE CHANG AND ADAMS LEASING STUDY: ARE THE PREDICTED ECONOMIC EFFECTS LIKELY TO OCCUR? (Apr. 2015) [hereinafter LIPE REVIEW]. The Lipe Review has a low publication profile. It is most readily available as an attachment to the July 1, 2015, letter in response to it by Andrew Chang, the coauthor of the Chamber Study. Letter from Andrew Chang to Fin. Accounting Standards Bd., Comment Letter 18: Leases (July 1, 2015), http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=LEASES-14 [hereinafter Chang Letter].

61. LIPE REVIEW, *supra* note 60, at 1.

the balance sheet resulting from a modification in "the fundamental economics of a company."[62] As a result:

> Moving information about leases from the financial statement footnotes to the balance sheet is unlikely to cause a large change in the lessees' cost of borrowing, and, in the numerical model in the [Chamber Study], if borrowing costs do not increase, then jobs and GDP are unaffected.[63]

The Lipe Review concluded that because the Chamber Study incorrectly predicts both a widespread increase in lessee borrowing costs and a redirection of funds by lessees seeking to deleverage, it "substantially overstates the loss of jobs and GDP reduction associated with the FASB's proposed lease accounting."[64] Although it acknowledged that the new rules "will undoubtedly affect some companies," the Lipe Review also concluded that "the net effect on jobs and GDP will likely be a tiny blip."[65]

Commentators at many stages of the leasing project observed that sophisticated investors, lenders, creditors, and rating agencies already recognize the flaw in lessee-constructed balance sheets and respond by reconstructing them to include capitalized leases.[66] Indeed, the SEC Report's empirical study had said as much.[67] The essence of the exposure draft was that lease capitalization and recording should be readily available to all, not just the few.

For some, a matter of fundamental principle was at stake. A comment by the Financial Accounting Standards Committee of the American Accounting Association ("Committee") stated that the "current accounting for leases (based on an ownership model) is probably the clearest example of a dysfunctional accounting standard because the rules-based approach of that standard has led to widespread non-compliance with the intent of standard setters to have lease contracts

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62. *Id.* "Financial statement users do not respond to mandated accounting changes as if the changes reflect shifts in the fundamental economics of the reporting entity." *Id.* at 9.

63. *Id.* at 1.

64. *Id.* at executive summary.

65. *Id.* at 1. Just as in the case of the Chamber Study, there was immediate and sharply negative feedback to the Lipe Review. Congressman Brad Sherman wrote that it deserves "widespread excoriation." Letter of Congressman Brad Sherman to Mr. Russell Golden, Chair, Fin. Standards Accounting Bd., Comment Letter 19: Leases (July 15, 2015), http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=LEASES-14. Among other things, the Chang Letter summarizes industry concerns about the negative effects of the proposed rules on financial ratios and debt covenants, including the concern expressed by one industry participant that they will "result in a de facto increase in the regulatory capital requirements of financial institutions." Chang Letter, *supra* note 60, at 2.

66. *See* Anthony H. Catanach, Jr. & J. Edward Ketz, *Economic Impacts of Capitalizing Leases: The ELF Study*, GRUMPY OLD ACCTS. BLOG (Jan. 2012), http://www19.homepage.villanova.edu/anthony.catanach/GOA%202012%20Archive%20Page.htm [hereinafter *Economic Impacts*] ("sophisticated financial analysts have been estimating lease obligations for at least two decades" and "rating agencies have been estimating lease obligations for several years").

67. The SEC had previously made the same basic point: "Sophisticated users, such as credit-rating agencies, often adjust balance sheets in their work so they can analyze companies as if all leases were reflected on the balance sheet." SEC REPORT, *supra* note 19, at 106.

reported on the balance sheet."[68] It decried the knife-edged accounting practices that had developed to allow firms to carve themselves out of the SFAS 13 definition of ownership and, hence, out of recording on the balance sheet.[69] The Committee considered the goal of recording all lease contracts on the balance sheet to be "important for a well-functioning accounting system."[70]

Despite the predictions of dire economic consequences caused by increased borrowing costs,[71] and despite the relative absence of data on increased compliance costs, the joint project continued on the path of requiring all leases to be recorded on the balance sheet.[72] Although there was an eleventh-hour effort by the Chamber and others to exclude private companies from the scope of the new rules,[73] early in 2016 the FASB and the IASB separately issued final rules requiring that virtually all leases be recorded on the balance sheet.

B. The FASB's End Result: ASU 2016-02

On February 25, 2016, the FASB formally updated its Accounting Standards Codification by issuing ASU 2016-02, a massive set of new rules on accounting for leases that update GAAP.[74] The FASB, like the IASB,[75] now requires almost all leases, both capital and operating, to be recorded on the lessee's balance sheet. According to FASB Chair Russell G. Golden, the guidance in the new rules "ends what the U.S. Securities and Exchange Commission and other stakeholders have identified as one of the largest forms of off-balance sheet accounting," the accounting for leases.[76]

ASU 2016-02 has extremely widespread implications because it affects "all companies and other organizations that lease assets such as real estate, airplanes, and manufacturing equipment."[77] Although the FASB and the IASB agreed throughout the project that operating lease liabilities should be put on the bal-

68. Yuri Biondi et al., *A Perspective on the Joint IASB/FASB Exposure Draft on Accounting for Leases*, 25 Acct. Horizons 861, 862 (2011) [hereinafter *Perspective*]. *Perspective* integrates earlier studies suggesting the need for reform.

69. *Id.* at 863.

70. *Id.* at 862.

71. *See* Equip. Leasing & Fin. Found., Economic Impacts of the Proposed Changes to Lease Accounting Standard (Dec. 2011). The ELF Study estimated an additional $2 trillion in reported debt as well as decreases to net income because of the front-loading effect in capitalized leases. In response, see *Economic Impacts*, *supra* note 66.

72. The FASB and the IASB issued three documents for public comment: a 2009 discussion paper, a 2010 exposure draft, and a 2013 exposure draft. *See Accounting Standards Update No. 2016-02, Leases (Topic 842)*, FASB in Focus, Feb. 25, 2016, at 2 [hereinafter FASB in Focus]. Together, the three documents generated more than 1,700 comment letters. The FASB also held more than 200 meetings with preparers and users, fifteen roundtables with more than 180 companies, and fifteen preparer workshops with representatives from more than ninety organizations. *Id.*

73. *See Chamber of Commerce Asks for Private Company Exemption to Planned Leases Standard*, Acct. & Compliance Alert (WG&L) (Feb. 11, 2016).

74. ASU 2016-02, *supra* note 3.

75. Int'l Accounting Standards Bd., IFRS 16, Leases (Jan. 2016) [hereinafter IFRS 16], http://eifrs.ifrs.org/eifrs/bnstandards/en/2016/ifrs16.pdf.

76. FASB in Focus, *supra* note 72, at 1.

77. *Id.* at 3.

ance sheet, they ultimately diverged with regard to how operating leases should be represented on income and cash flow statements. The remainder of Part IV analyzes the final FASB rules, noting only the most important way they diverge from the final IFRS promulgated by the IASB.[78]

C. The Threshold Question: Is It a Lease?

1. The Scope of ASC 842 and Basic Definition of "Lease"

The threshold question about the application of ASC 842 is whether a contract is or contains a "lease." As we shall see in more detail, the definition of lease has changed. In short, the test is whether a contract transfers the right to control the use of an asset that is explicitly or implicitly identified. More specifically, a lease is "a contract, or part of a contract, that conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time[79] in exchange for consideration."[80] Although ASC 842 applies to all contracts that are leases of land and depreciable assets, it has a short-term exemption for leases of twelve months or less.[81] Despite the change in definition, most contracts that have in the past been classified as leases, such as those for office spaces or the use of equipment, will continue to be classified as leases. The consequences are now different because they all must be capitalized and recorded on the balance sheet. However, a new test for "control" and other nuances means that some contracts previously classified as leases may avoid lease classification and the resulting capitalization.

In deciding whether a lease exists, the label of the contract is not determinative.[82] What matters is whether the substance of the contract is within the definition of a lease. Form does not control substance. ASC 842 clearly applies to many arrangements even though they are not all labeled as leases. Indeed, ASC 842 can apply to arrangements that, on their face, disavow any intent to

78. The IASB's final rules were promulgated as IFRS 16, *supra* note 75 ("The FASB and the IASB have reached the same conclusions in many areas of lease accounting, including requiring leases to be reported on the balance sheet, how to define a lease, and how lease liabilities are initially measured."). FASB in Focus, *supra* note 72, at 3.

79. A period of time may be described "in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce)." ASC 842-10-15-3.

80. ASC 842-1-15-3.

81. ASU 2016-02, *supra* note 3, at 29 (giving lessees under leases with lease terms of twelve months or less an election not to capitalize those leases). However, no lease that contains a purchase option is eligible for this exemption. *Id.* There is no exception for leases of very small dollar amounts, such as rent paid for computers. *Id.* at 8. By contrast, the IASB included a lessee recognition and measurement exemption for leases of assets with values of less than $5,000. *Id.* However, ASU 2016-02 permits lessees to report leases with similar characteristics at the portfolio level. Fin. Accounting Standards Bd., Project Update: Lease—Joint Project of the FASB and the IASB (Nov. 19, 2015), http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=900000011123.

82. The same is true for federal income tax purposes. *See* Sun Oil Co. v. Comm'r, 562 F.2d 258, 262 (3d Cir. 1977) ("Regardless of whether the parties honestly believe the transaction to be a lease, where the documents they have executed fully embody the elements of their bargain, it is the documents themselves, not the parties' conception of them, which must govern the legal characterization of the transaction."), *cert. denied*, 436 U.S. 944 (1978).

create a lease. Conversely, ASC 842 does not apply to some arrangements that are labeled leases. In part this is a matter of the scope of the project. Certain major asset classes are excluded from the new leasing standard. For example, ASC 842 does not apply to leases of intangible assets; leases to explore for or use minerals; leases of biological assets, including timber; leases of inventory; or leases of assets under construction.[83]

A firm must determine whether a contract is or contains a lease at the inception of the contract.[84] There are two basic questions to determine whether there is a lease: (1) Does the contract involve the use of an identified asset? (2) Does the contract transfer the right to control the use of that asset? If a single contract contains both a lease component and a non-lease component, the two should be separated.[85]

2. First Test for Lease: Is There Use of an "Identified Asset"?

The first question under the new lease definition is whether a contract involves the use of an "identified asset." An asset can be "identified" either because it is "explicitly specified" in the contract or "implicitly specified" at the time it is made available for use.[86] An asset can be implicitly identified if, for example, the supplier has only one asset that can satisfy the arrangement. An asset can be a "physically distinct" portion of a larger asset, such as two specific floors in a four-story office building. On the other hand, a portion of the capacity of an asset or other portion of an asset that is not physically distinct "is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the

83. ASC 842-10-15-1(a)–(e). The Committee reacted negatively to the appearance of these large exceptions in the first exposure draft: "The proposed scope exceptions (e.g., oil and gas, regenerative assets) involve large and material assets and create loopholes that managers know how to exploit." *Perspective*, *supra* note 68, at 7 (citations omitted). Leases of inventory and leases of assets under construction were originally included in the scope of the project but were ultimately removed. *Bring It On—Discussing the FASB's New Leases Standard*, Deloitte DBriefs Webcast (Mar. 15, 2016, 2:00 PM EST), http://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/march/2016/dbriefs-bring-it-on-discussing-the-fasbs-new-leases-standard.html [hereinafter *New Leases Standard*].

84. ASC 842-10-15-2. There is no need to reassess whether a contract is or contains a lease unless the terms and conditions of the contract are changed. ASC 842-10-15-6.

85. Contracts with lease components often also involve a contract for goods or services. Thus, a contract may contain both a lease of a car and an arrangement for servicing the car over a period of use. Similarly, a lease of real estate may also include a maintenance contract. *See New Lease Standard*, *supra* note 83; Joseph Sebik, *A Paradigm Shift in Lessee Accounting: An Explanation of the New U.S. Leasing Guidance*, Acct. Pol'y & Prac. Rep., Mar. 11, 2016, at 3 [hereinafter *Paradigm Shift*]. It may be difficult to distinguish a lease when a contract is not in the form of a conventional lease. *Id.* at 6–7 ("For instance, a contract may be called a service agreement or a long-term product supply contract, as is the case of a multiple-element arrangement wherein an asset is supplied 'without cost' as long as the entity using the asset agrees to purchase a defined quantity of the consumables that are used by that asset. For example, if a supplier provides a customer a diagnostic machine and the customer agrees to purchase a given quantity of blood or urine test kits that include a testing reagent over a predetermined period of time. These types of contracts are referred to as supply agreements but essentially have a lease of an asset embedded within the contract.").

86. ASC 842-10-15-9.

economic benefits of the use of the asset."[87] Thus, the use of a natural gas pipeline or fiber-optic cable on a shared basis with other users does not involve an identified asset.[88] The idea is that although there is a transfer of a right to use an asset, there is no transfer of a right to use any discrete part of it. However, the economics of the two might appear to be the same, and it is unclear why one should be considered an "identified asset" and the other not. As we shall see, however, even if a capacity contract involves an identified asset, it may fall outside lease classification if the transferee lacks sufficient control over the use of the asset.[89]

A further question is whether an asset is disqualified from being "identified" because the supplier has the right to substitute a different asset. Even if an asset is specified, the transferee does not have the right to use an identified asset "if the supplier has the substantive right to substitute the asset throughout the period of use."[90] The supplier's right is considered "substantive" only if it has the practical ability to substitute and if it would benefit from exercising its right to substitute.[91] If the supplier's substitution rights are substantive, the contract is a service contract rather than a lease. It is "characterized by the acquiring of output or utility from the asset rather than the use of the asset."[92] The requirement that the supplier benefit from the substitution is a new rule that makes it more difficult to avoid lease classification by a simple contractual right to substitute. The formal right to substitute must be economically meaningful. The contractual right is not economically meaningful if, for example, the costs of physical substitution are too great to give the supplier a net economic benefit.[93]

3. Second Test for Lease: Is There a Transfer of Control of the Use of the Identified Asset?

The second question under the new lease definition is whether the contract transfers the right to "control the use" of the identified asset. Indeed, the core change in the lease definition is its new emphasis on the concept of control.[94] The new control concept itself has two components: a benefits test and a power test. To determine whether a contract transfers the right to control the

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87. ASC 842-10-15-16.

88. *Id.; see also New Leases Standard*, *supra* note 83.

89. ASC 842-10-55-1 (containing a flowchart that depicts the decision process for identifying whether a contract is or contains a lease).

90. ASC 842-10-15-10.

91. *Id.* It would benefit economically if "the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset." ASC 842-10-15-10(b). An entity's evaluation of whether a supplier's right to substitute is meaningful must be based on the circumstances at the inception of the contract and "shall exclude consideration of future events that, at inception, are not considered likely to occur." ASC 842-10-15-11.

92. *Paradigm Shift*, *supra* note 85, at 8.

93. ASC 842-10-15-12. For a tax case probing the economic significance of a purported lessee's substitution rights, See Sun Oil Co. v. Comm'r, 562 F.2d 258 (3d Cir. 1977), *cert. denied*, 436 U.S. 944 (1978). Neither a supplier's right nor obligation to substitute in the event of repair, operational failure, or upgrade disqualifies the asset from being "identified." ASC 842-10-15-14.

94. This is similar to the new revenue standard and the new consolidation standard.

use of an identified asset for a period of time, a firm must assess whether, throughout the period of use, it has both (a) the right to obtain substantially all of the economic benefits from the use of the identified asset and (b) the right to direct the use of the identified asset.[95] This "right to direct the use" (or "power") component is what is new about the definition of control. In short, for a lease to exist, the transferee must get both substantially all the economic benefits from the use of an identified asset and decision-making authority over the use of that asset.

(i). The "Benefit" Requirement: The Right to Obtain Substantially All the Economic Benefits. The first necessary element of the control test is the right to obtain substantially all the economic benefits from an identified asset. The definition of "economic benefits" is extremely broad. Economic benefits from the use of an asset "include its primary output and by-products (including potential cash flows derived from these items) and other economic benefits from using the asset that could be realized from a commercial transaction with a third party."[96] Consider, for example, a solar facility that generates electricity and receives "renewable energy credits" for generating that electricity. Those credits can be sold to a third party and hence have value. The rule of thumb is that any piece of output that can be monetized should be considered a by-product for the purposes of this test.[97] Tax attributes that cannot be sold are not included.

The customer is not required to receive every economic benefit from all possible uses of the identified asset to meet this test. The focus is on the economic benefits "that result from use of the asset within the defined scope of the customer's right to use the asset in the contract."[98] For example, a contract may merely provide a right to use a motor vehicle only within a particular territory and yet remain a lease. Similarly, if a contract requires payment of a portion of the cash flows from the use of an asset as consideration, "those cash flows paid as consideration shall be considered to be part of the economic benefits that the customer obtains from the use of the asset."[99] Consider, for example, shopping center leases, which frequently require fixed rent plus a payment of a percentage of a retailer's gross receipts. The requirement to pay "a percentage of sales from use of retail space as consideration for that use . . . does not prevent the [tenant] from having the right to obtain substantially all of the economic benefits from use of the retail space."[100] Even the portion of cash flow from sales the tenant must pay as rent is considered economic benefit to the tenant.

(ii). The "Power" Requirement: The Right to Direct the Use. The second necessary element of the control test is the "right to direct the use" of the asset. This is the new "power" element of the control test. To have the right to direct the use of the

95. ASC 842-10-15-4.
96. ASC 842-10-15-17. The economic benefits of the use of an asset can be obtained in many ways, such as by using, subleasing, or holding the asset.
97. *New Leases Standard*, *supra* note 83.
98. ASC 842-10-15-18.
99. ASC 842-10-15-19.
100. *Id.*

asset, the customer must have the right to direct both "how and for what purpose" the asset is used throughout the term. This right to direct "how and for what purpose" concept is both new and fundamental. This language refers to the big decisions with respect to an asset. If the supplier makes them, there is no lease because the customer does not have the right to direct the use of the asset and hence does not control it. If the customer makes the fundamental decisions, the control test is satisfied. A customer can have the requisite right to direct the use of an asset in either one of two basic situations.

First, a customer has the requisite right to direct the use if it "has the right to direct how and for what purposes the asset is used throughout the period of use."[101] It has the requisite right to direct the use "if, within the scope of its right of use defined in the contract, it can change how and for what purposes the asset is used."[102] Decision-making rights are relevant "when they affect the economic benefits to be derived from use."[103] Thus, a customer has the right to direct how and for what purpose an asset is used if it can change the type of output that is produced, including the mix of products sold from a retail unit, or when, where, or how much output is produced.[104]

Second, a customer can have the requisite right to direct the use even in some situations in which the relevant decisions about "how and for what purpose" the asset is used are predetermined. Consider, for example, situations in which the use is predetermined either by contractual restrictions or by the design of the asset.[105] Despite the predetermination, the customer can have the requisite "right to direct the use" if one or both of the following conditions exists: (a) the customer has the right to operate the asset without the supplier having the right to change the operating instructions, or (b) the customer designed the asset in a way that predetermines "how and for what purpose" the asset will be used.[106]

Return to the example of a shopping center lease of a defined space,[107] which typically limits the tenant's use in many ways. For example, it may require the tenant to operate a particular type of outlet, such as a pharmacy; it may limit the categories of products that may be sold; it may require that the outlet remain open for defined business hours; and it may require the tenant to contribute financially to shopping center-wide advertisement and maintenance that is centrally managed. Even though the use is circumscribed, the contract gives the customer sufficient control to classify the arrangement as a lease. Most basically, a typical shopping center tenant falls within the first basic situation because it has the right to direct "how and for what purpose" the space is used "within

101. ASC 842-10-15-20(a).
102. ASC 842-10-15-24.
103. *Id.*
104. ASC 842-10-15-25. Rights that are limited to operating or managing the asset are not sufficient. ASC 842-10-15-26.
105. ASC 842-10-15-21.
106. ASC 842-10-15-20.
107. Contrast a contract for concession space that gives the provider the right to change the location of the space allocated to the customer. ASC 842-10-55-52.

the scope of its contractual right," which is limited only by the contractual confines of its membership within the broader community of economically interdependent businesses. More specifically, it has decision-making rights over "the mix of products sold."[108] It gets to decide both the mix of products that will be sold and their price.[109] In addition, control over the use is not taken away because the supplier of the space is exercising protective rights. A "protective right" is a contractual provision either to protect parties other than the user or to ensure legal compliance. For example, a contract "may include terms and conditions designed to protect the supplier's interest in the asset or other assets, to protect its personnel, or to ensure the supplier's compliance with law or regulations."[110] Contractual provisions might, for example, specify the time or place for use of an asset or may require particular operating practices or requirements to contribute to common expenses. Although protective provisions limit the scope of the customer's use, they do not, in isolation, defeat the customer's requisite right to direct the use. Finally, even if the decisions on "how and for what purpose" were somehow considered to be predetermined, the customer would appear to have the right to direct the use because it has the right to operate the asset without the supplier's having the right to change the operating instructions. Indeed, if the shopping center lease had been for space to operate a movie theater, the tenant may have designed the theater in a way that predetermined "how and for what purpose" the asset would be used.

There are some arrangements previously classified as leases that the new "power" element—the "right to direct the use" requirement—may cause to fall outside the definition of lease. Output arrangements in particular have been identified as contracts that might fall outside the definition of lease because of its new control component.[111] For example, consider a contract to purchase all the output generated by a particular power plant for a period of years. Even if the purchaser has the right to substantially all the benefits from the operation of the power plant, it may not have the right to direct "how and for what purpose" the plant operates.[112] However, the result may differ if the customer designed the power plant and "there are no decisions to be made about whether, when, or how much electricity will be produced because the design of the asset has predetermined these decisions."[113]

4. The Lease Term and the Effect of Options

Deciding the length of the lease term is critical. The longer the period of the rental commitment, the greater the lease liability and related right-of-use asset that must be recorded on the balance sheet. Here, again, the lessee must deter-

108. ASC 842-10-55-70(b).
109. *Id.*
110. ASC 842-10-15-24.
111. *New Leases Standard*, *supra* note 83.
112. ASC 842-10-55-116.
113. ASC 842-10-55-108; *see also* ASC 842-10-55-109—123; *New Lease Standard*, *supra* note 83.

mine the term as of the commencement date. The lessee cannot simply report whatever base lease term is specified in the contract. Rather, the lessee must determine[114] a lease term that includes both the noncancelable period of the lease and any periods that are:

(a) covered by an option to extend that the lessee is reasonably certain to exercise;

(b) covered by an option to terminate that the lessee is reasonably certain not to exercise; or

(c) covered by an option to extend (or not to terminate) if the exercise of the option is controlled by the lessor.[115]

In making its determination of reasonable certainty, the lessee must consider "all relevant factors that create an economic incentive for the lessee (that is, contract-based, asset-based, entity-based and market-based factors)."[116] For example, a lessee should consider whether there are leasehold improvements that are expected to have significant economic value when an option is exercisable.[117]

Lessees are required to reassess the lease term or a lessee option to purchase the underlying asset only if any of the following occurs:

(a) There is a significant event or change in circumstances that is in the control of the lessee that directly affects whether it is reasonably certain to exercise or not to exercise an option to extend or terminate the lease.

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114. The Committee indicated a preference for including all lease renewal periods in the initial measurement of the lease to block opportunistic behavior by management. *Perspective*, *supra* note 68, at 5–6 ("Using convoluted tests like 'term that is more likely than not to occur' . . . creates a loophole which management can exploit. Management can argue that certain renewal options will not meet the 'more likely than not' test. Experimental evidence suggest that auditors are likely to go along with these managerial judgments thus defeating the intent of the standard." (citations omitted)).

115. ASC 842-10-30-1.

116. ASC 842-10-30-2. ASC 842-10-55-26 reiterates the importance of all economic factors relevant to the assessment of reasonable certainty. The federal income tax law also considers all relevant factors to determine whether an option is likely to be exercised. *See, e.g.*, Sun Oil Co. v. Comm'r, 562 F.2d 258, 267–68 (1977), *cert. denied*, 436 U.S. 944 (1978). The court concluded that, in economic reality, a lessor's right to reject an offer was illusory. *Id.* at 265 ("The limitations of time, distance, and subject matter also erode whatever substance may have existed in the lessor's rights to reject an offer."). In *Hilton v. Commissioner*, the court reviewed conflicting expert testimony on the likelihood lease options would be exercised and considered among other things the expected useful life of the neighborhood for purposes of the tenant. 74 T.C. 305, 354 (1980), *aff'd per curiam*, 671 F.2d 316 (9th Cir. 1982). Courts have reached different conclusions on whether lease options are likely to be exercised. *See, e.g.*, Frank Lyon Co. v. United States, 435 U.S. 561, 560–70 (1978) (discussing the conflicting opinions in the lower courts). Analogous recent authority also indicates that a broader pattern of behavior may influence a court's decision on the likelihood of option exercise. *Cf.* Sun Capital Partners III, LP v. New Eng. Teamsters & Trucking Indus. Pension Fund, 172 F. Supp. 3d 447 (D. Mass. 2016) (finding a partnership between two private equity firms that were formally separate). The "smooth coordination" of the two was "indicative" of a shared control. *Id.* at 464.

117. ASC 842-10-55-26(b). The same principles apply to assess an option to purchase the underlying asset. ASC 842-10-30-3.

(b) There is an event written into the contract[118] that obliges the lessee to exercise or not to exercise an option to extend or terminate the lease.

(c) A lessee elects to exercise an option even though it had previously determined that it was not reasonably certain to do so.

(d) The lessee elects not to exercise an option even though it had previously determined it was reasonably certain to do so.[119]

Thus, lessees must monitor for the occurrence of any of these events and reassess the lease term if such an event occurs. For example, a lessee must reassess the lease term if it makes such significant leasehold improvements that it becomes reasonably certain to exercise an option to renew.[120] The key factor in this example is that the lessee controlled the change in circumstances. A change in market-based factors alone would not require a lessee to reassess the lease term.[121] For example, the lessee does not control an increase in value stemming from improved transportation access effected by a third party. A reassessment of the lease term may lead to a remeasurement of the lease liability and the corresponding right-of-use asset for balance sheet purposes. It may also lead to a reclassification of the lease for income statement purposes.[122]

D. The Lessee's Balance Sheet: The Crux of the Matter

1. The Theoretical Change from Ownership to Use

The most important change in the new rules is that lessees are required to record most lease liabilities on their balance sheets.[123] Lessees under leases for more than twelve months must now record the lease liability on their balance sheets and also record a corresponding right-of-use asset. Both the liability and the asset must include the present value of the future lease payments. This dramatic result reflects a major theoretical shift with respect to balance sheet recording. The new rules abandon the ownership model and replace it with a right-of-use model.

118. See ASC 842-10-30-5 for initial measurement of the lease payments on the commencement date.

119. ASC 842-10-35-1.

120. ASC 842-10-55-28.

121. ASC 842-10-55-29.

122. *See* PricewaterhouseCoopers, The Overhaul of Lease Accounting: Catalyst for Change in Corporate Real Estate 3 (2016) [hereinafter Catalyst], http://www.pwc.com/us/en/asset-management/real-estate/publications/assets/pwc-overhaul-of-lease-accounting.pdf.

123. The new rules also affect lessors, but to a much more minor extent. Because accounting for leases by lessees rather than lessors was the main focus of ASC 842, there is no fundamental change to accounting by lessors. Accounting for lessors is largely unchanged from current Topic 840 in the Accounting Standards Codification. FASB in Focus, *supra* note 72, at 1. However, the new rules contain "some targeted improvements that are intended to align lessor accounting with the lessee accounting model and with the updated revenue recognition guidance issued in 2014." Press Release, Fin. Accounting Standards Bd., FASB Issues New Guidance of Lease Accounting (Feb. 25, 2016), http://www.fasb.org/jsp/FASB/FASBContent_C/NewsPage&cid=1176167901466.

a. The Underinclusive "Ownership" Model. Recall that the core concept of the old rules was the "ownership" model. More specifically, the focus had been on ownership of the underlying asset. A lessee was not required to record a lease on its balance sheet unless it was a capital lease that gave the lessee substantially all of the benefits and risks incident to ownership of the underlying asset. If a lessee could flunk each of the four ownership tests of SFAS 13, the lease was an operating lease that was not recorded on the balance sheet.[124] The ownership tests were easy to flunk because they were mechanical and involved bright lines that were often easy to draft around. Knife-edged accounting developed that allowed firms to carve themselves just outside the line and hence avoid recording the lease obligation on the balance sheet.

The ownership model kept an extremely wide range of leases off balance sheets. At one extreme were leases that did indeed effectively transfer substantive ownership of the underlying asset but were structured to flunk the SFAS 13 ownership tests.[125] In the middle were leases that represented a significant financial obligation and transferred many of the risks and benefits of the underlying asset but did not approach full ownership. At the other extreme were leases that represented fairly minor financial obligations and transferred a relatively small portion of the benefits and burdens of the underlying asset.

b. The Extremely Inclusive Right-of-Use Model. The right-of-use theory in the new rules requires that a wide range of operating leases be capitalized and recorded on the balance sheet. As we have seen, the new rules define a lease as a contract that conveys the right to control the use of identified property for a period of time in exchange for consideration. The new rules provide that the contractual right of use is itself an asset that must be recorded on the balance sheet. Ownership of the benefits and burdens of the underlying asset is now irrelevant for the purposes of requiring the lease to be recorded on the balance sheet.[126] Similarly, the total contractual lease obligation should be recorded on the balance sheet as a liability. The starting point for both is the present value of the required lease payments.

c. Right to Use Is a Redirected Ownership Model. The right-of-use model is, in effect, an ownership model with a different focus than the ownership model of SFAS 13. SFAS 13 focuses on ownership of the *underlying asset.* It asks the lessee to record on the balance sheet only if it has substantially all the benefits and burdens associated with the underlying asset. The new rules in ASC 842 focus on the benefits and burdens associated with the lessee's *leasehold interest* itself. The new rules simply ask the lessee to record the benefits and burdens it has under the lease, ignoring the benefits and burdens that may lie elsewhere.

124. If the lease was from an SPE, the lessee might have been indirectly required to record the lease liability if it had been required to prepare consolidated financial statements with the SPE.

125. Many leases that were treated as operating leases under SFAS 13 were treated as mortgages for federal income tax purposes. *See* Weidner, *supra* note 1, at 487.

126. As we shall see, ownership of the benefits and burdens of the underlying asset remains relevant for purposes of classifying the lease as a finance lease as opposed to an operating lease for other financial statement purposes.

Although accounting rules and legal rules are designed for different purposes, it may be useful to point out that the legal system has long considered the rights and liabilities associated with ownership of leasehold interests. The leasehold estate is one of a handful of basic estates in land,[127] the most complete of which is the fee simple. When the owner of a fee simple estate in an asset transfers a right to use the asset for a fixed term, the fee owner becomes a specialized grantor called a lessor, and the recipient becomes a specialized grantee called a lessee. For the duration of the term, the lessee receives the present possessory interest with respect to the underlying asset, which is the right to occupy and control it. During that term, the landlord has a future interest called a "reversion." It is a future interest because although it exists throughout the lease term, it will not become possessory until the term ends.

The conveyance of a leasehold estate differs from the conveyance of other estates in land because the lease typically contains many continuing promises of both parties. Shopping center leases and financing leases are examples of situations in which both the landlord and the lessee make many continuing promises. Bankruptcy law in particular closely examines the multiplicity of covenants. Section 365 of the Bankruptcy Code empowers the trustee in bankruptcy to assume or reject a debtor's executory contracts.[128] A lease is an executory contract for this purpose because both the landlord and the lessee have material obligations yet to be performed. Accordingly, the lessee's lease agreement represents both an asset (the landlord's unperformed promises) and a liability (the lessee's unperformed promises, not the least of which is the promise to pay rent). Once the asset and liability are identified, however, a subsidiary question in bankruptcy is whether the lease is in substance a financing transaction. If the lease is a finance lease—that is, if it is in substance a mortgage—then the lessee may be able to remain in possession and have the mortgage obligation restructured as part of a bankruptcy reorganization plan.[129] The new ASC 842 rules adopt an analogous two-tier analysis. First, they ask whether there is a lease for more than twelve months. If there is, it must be capitalized and recorded on the balance sheet as representing both an asset and a liability. Second, they ask whether it is a finance lease. If so, it must be treated as a mortgage on the income statement and recorded separately on the balance sheet.[130]

2. Determining the Lease Liability and Right-of-Use Asset

The basic rule implementing the right-of-use model is that on the lease commencement date, a lessee shall recognize both a lease liability and a corresponding right-of-use asset.[131]

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127. Others are the fee simple absolute (the highest quantum of ownership), the defeasible fees, and the life estate. These interests can be held in personal property.

128. 11 U.S.C. § 365 (2012).

129. *See* Grant Nelson & Dale Whitman, Real Estate Finance Law 73 (5th ed. 2007).

130. ASC 842-20-25-5.

131. A lessee may elect not to apply this recognition requirement to a short-term lease, which is one that at the commencement date "has a lease term of 12 months or less and does not include an

a. Determining the Lease Liability. Lease liability is the term used to describe the obligation to make payments under a lease as opposed to other debt. The starting point to determine the lease liability is to identify the lease payments that have not yet been made. The next step is to reduce these future lease payments to their present value by applying an appropriate discount rate.

The total lease payments the lessee must capitalize include a variety of components:

(a) fixed payments, including in substance fixed payments;

(b) variable lease payments that depend on an index or a rate;

(c) the exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise the option;

(d) payments for penalties for terminating the lease if the lease term reflects the lessee's exercising an option to terminate the lease; and

(e) amounts the lessee will probably owe under residual value guarantees.[132]

The first two items require more explanation than the last three. Fixed payments are specified in the lease and fixed over the lease term. "In substance" fixed payments are variable payments that include a floor or minimum amount. Variable payments need not be included as lease payments unless they are based on an index or a rate.[133] Payments based on usage of the asset or performance are not included. Consider, for example, a shopping-center tenant that contracts to pay a fixed rent plus 2 percent of gross sales. The amount generated by the 2 percent is a variable payment that is not included in the lease liability because it does not depend on an index or a rate.[134] With regard to the third item, lessees must exercise judgment to decide whether they are reasonably certain to exercise an option to purchase. Similarly, they must exercise judgment to determine how much they will probably owe under a residual value guarantee.

Once the future lease payments are identified, the question becomes what discount rate should be applied to reduce them to their present value. Theoretically, there are three basic discount rates that might be used: (1) a risk-free rate (such as the rate on a Treasury obligation of the same term), (2) a lessee-specific borrowing rate that will reflect the strength of the lessee's credit, or (3) a lease-specific interest rate (implicit in the terms of the lease). Under ASC 842, the choice of discount rate depends on both available financial information and whether the lessee is a public business entity.

option to purchase the underlying asset that the lessee is reasonably certain to exercise." ASC 842-20-25-2.

132. ASC 842-10-30-5 also requires the lessee to include in lease payments any fees it pays to the owners of an SPE to structure the transaction.

133. A lessee will reassess variable lease payments that depend on an index only if the lease liability is remeasured for another reason independent of a change in the reference index.

134. ASC 842-10-55-233.

A lessee should apply the discount rate for the lease at lease commencement.[135] It should use the "rate implicit in the lease,"[136] that is, the rate the lessor charges in the lease whenever that rate is readily determinable.[137] If, as is often the case, the rate implicit in the lease is not readily determinable, a lessee is to use its incremental borrowing rate. A public business entity may use a portfolio approach, which applies a single discount rate to the portfolio of new leases, if the leases are similar.[138] If the lessee is not a public business entity, it may use a risk-free discount rate determined by using a period comparable to the lease term.[139] The price to pay for making this simple choice is that both the lease liability and the right-of-use asset will appear on the balance sheet at higher amounts.[140] The irony in the overall approach is that the recorded liability on a similar lease will be smaller for a more risky firm than it would be for a firm that is less risky. The riskier the firm, the higher the discount rate; and the higher the discount rate, the lower the present value of the future rent stream.[141]

(ii). Determining the Right-of-Use Asset. Right-of-use asset is the term used to enable readers of financial statements to readily distinguish assets that are leased from those that are directly owned. Right-of-use assets are those offset by lease liabilities. In the simplest situation, a right-of-use asset will be recorded on the balance sheet at the same amount as the lease liability, that is, at the present value of the future rent payments. However, the lease asset must also include any lease payments made to the lessor prior to the commencement date as well as any initial direct lessee costs.[142]

135. ASC 842-20-30-1(a).

136. ASU 2016-02, *supra* note 3, at 99 (defining "rate implicit in the lease" as follows: "The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor.").

137. ASC 842-20-30-3.

138. ASC 842-20-55-20.

139. ASC 842-20-30-3.

140. In general, there is no requirement to reassess the discount rate unless there is a modification of the lease that does not result in a separate contract.

141. *See* Catalyst, *supra* note 122 at 7–8 ("Although counter-intuitive, under the new standard, companies with a better credit profile and lower borrowing costs will record a larger lease liability as a result of discounting the associated lease payments based on a lower incremental borrowing rate when compared to a company with a lesser credit and higher borrowing costs, relative to the same lease.").

142. ASC 842-20-30-5. A more complete statement of the amount for the right-of-use asset is lease liability + unamortized initial direct costs + prepaid rents – any accrued rents – the remaining balance of any lease incentives received.

E. The Income Statement

1. Distinguishing a Finance Lease from an Operating Lease

Because all leases must now be recorded on the balance sheet, the old distinction between capital leases and operating leases no longer exists for the purposes of balance sheet inclusion. However, the old distinction, modified slightly, continues for other financial statement purposes. The new rules replace "capital" lease with "finance" lease.[143] Finance leases and operating leases continue to be reported differently on the income statement. In the language of accounting, there is a different expense profile or expense recognition for each type of lease. The expense profile, in turn, affects some key financial ratios.

When a lease begins, a lessee must classify it either as a finance lease or an operating lease.[144] A lessee is required to classify a lease as a finance lease (and a lessor is required to classify it as a sales-type lease) whenever the lease meets any of the following five criteria:

(a) The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

(b) The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

(c) The lease term is for the major part of the remaining economic life of the underlying asset.[145]

(d) The present value of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.

(e) The underlying asset is so specialized that it is expected to have no alternative use to the lessor at the end of the lease term.[146]

When none of these factors is present, the lessee is required to classify the lease as an operating lease.[147]

The first four of these factors are, to differing extents, very much like the SFAS 13 tests for a capital lease. The first factor, concerning transfer of asset ownership to the lessee, is identical. The second factor, concerning a lessee purchase option, replaces the concept of "bargain purchase option" with the concept of a purchase

143. ASC 842-10-25-2.

144. *Id.* An entity shall not later reassess lease classification unless the contract is modified and the modification is not accounted for as a separate contract. A lessee shall also reassess the lease classification "if there is a change in the lease term or the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset." ASC 842-10-25-1.

145. This criterion shall not be used if the commencement date is at or near the end of the asset's economic useful life.

146. ASC 842-10-25-2.

147. ASC 842-10-25-3. Using a related but different test, a lessor shall classify the lease as either a direct financing lease or an operating lease. ASC 842-10-25-3(b).

option "that the lessee is reasonably likely to exercise," presumably for reasons beyond a bargain price. The third factor, addressing the portion of the economic life of the asset transferred by the lease, eliminates the 75 percent bright-line rule and asks simply whether the lease is for the major part of the remaining economic life of the asset. No longer may lessees flunk the test by claiming that their leases fall just outside the 75 percent line. Similarly, the fourth factor, which looks at whether the lessee has paid most of the asset's value, eliminates the 90 percent test and asks simply whether the lease payments equal substantially all of the asset's fair value. Here again, lessees may no longer claim that they flunk the test because they fall just outside the 90 percent bright line.[148] The fifth factor is new and asks whether the asset is so specialized that it is not expected to have any alternative use to the lessor at the end of the term.[149] This factor is related to the others. For example, a lessor that will have no use for the asset at the end of the term will presumably charge rent that equals or exceeds the asset's value.

The new tests for a finance lease shift from bright-line rules to broader principles that require an exercise of judgment.[150] The underlying accounting principle remains ownership[151] of the underlying asset: a lease is a finance lease if the lessee has substantially all the benefits and burdens of the underlying asset. Because the new finance lease definition is so similar to the old capital lease definition, most agreements that were capital leases under the old rules are likely to be finance leases under the new rules. For example, a lease of a piece of equipment for most of its useful life will continue to be a finance lease. Similarly, most operating leases under the old rule will continue to be operating leases under the new rule. For example, most leases of office space are likely to continue to be operating leases, although they now must be capitalized

148. However, a lessee is permitted some limited use of bright-line guidance. For example, it may assume that 75 percent or more of the remaining life of the asset is "the major part" of the remaining economic life of the asset. ASC 842-10-55-2. Similarly, it may assume that 90 percent or more of the fair value of the underlying asset amounts to substantially all of its fair value.

149. ASC 842-10-25-2(e).

150. *Lessee Accounting Under the New Leasing Standard*, PricewaterhouseCoopers (July 14, 2016), http://www.pwc.com/us/en/cfodirect/multimedia/videos/lessee-accounting-fasb-leasing-standard.html.

151. The federal income tax law has long recognized that in the case of complex commercial leasing arrangements, more than one person can plausibly be seen as the owner. The U.S. Supreme Court has allowed taxpayers great flexibility in deciding whether the landlord or the tenant is considered the owner. In the leading case on the subject, *Frank Lyon Co. v. United States*, 435 U.S. 561, 560–570 (1978), the Court made two statements of the test. In what is referred to as the "long form" of the test, the Court stated, "where . . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." *Id.* at 584. It followed that statement with what is referred to as the "short form" of the same test: "Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes." *Id.*; *see also* Comm'r v. Bollinger, 485 U.S. 340, 344 (1988) (in a case involving the use of single-purpose financing entities, the court said, "[t]he problem we face here is that two different taxpayers can plausibly be regarded as the owner").

and recorded on balance sheets. However, some leases that were operating leases under the old rules because they were structured to fall just outside the old bright lines will be finance leases under the new rules. Because both now must be capitalized, the basic impact of the distinction is on the lessee's expense profile.[152]

2. The Two Different Expense Profiles

Over the life of the lease, the financial statements must characterize the payments on the lease, reduce the lease liability each year as the rent is paid, and reduce the right-of-use asset as its life expires. The characterization differs depending on whether the lease is a finance lease or an operating lease.

a. The Finance Lease. If a lease is a finance lease, it will be treated similarly to a capital lease today. The annual lease expense must be broken down into two components to be recognized on the income statement. The income statement must reflect both "amortization of the right of use asset" and "interest on the lease liability."[153] Recall that the right-of-use asset appears on the balance sheet at an amount equal to the present value of the lease payments.[154] This capitalized right-of-use asset must be written down, or amortized, on a straight-line basis over the life of the lease.[155] Amortization of the right-of-use asset is treated like straight-line depreciation of a tangible asset purchased with a mortgage. The interest on the lease liability is deemed to be the total lease liability multiplied by the discount rate that was used to value the lease liability.[156] Because the amortization of the right-of-use asset is deemed to be constant and the interest expense will be measured on the declining balance, this approach will tend to front load the total lease expense in the early years.[157]

b. The Operating Lease. If a lease is an operating lease, it will be treated similarly to the way it is treated today. The income statement will reflect an annual lease expense as part of the lessee's computation of income from continuing operations.[158] The annual expense is to be recognized on a straight-line basis. Annual lease expense is computed by calculating the total lease expense for the entire lease term and deducting it on a straight-line basis over the remaining lease

152. *See* Catalyst, *supra* note 122, at 3 ("While bright lines no longer exist, we believe that a reasonable approach may be to consider the previous percentages when determining lease classification [i.e., 75% of the economic life of the underlying asset and 90% or more of the fair value of the underlying asset].").

153. ASC 842-20-25-5. The income statement must also reflect any variable lease payments not included in the lease liability in the period in which the obligation for those payments is incurred as well as any impairment of the right-of-use asset. *Id.*

154. This ignores, for the sake of simplicity, any additional pre-commencement or initial costs.

155. ASC 842-20-35-7.

156. This is referred to as the effective interest rate method.

157. At the end of the lease term, the sum of each of these two amounts for the prior years—the total amortization expenses plus the total interest expenses—should equal the total rent paid in cash over the years.

158. ASC 842-20-45-4(b) ("For operating leases, lease expense shall be included in the lessee's income from continuing operations.").

term.[159] Because lease expense often increases over time, the straight-line method of reporting lease expense may overstate lease expense in the early years.[160]

c. The Distinction on the Balance Sheet. Because finance leases and operating leases are treated differently on the income statement, it is not surprising that the distinction between the two still has some residual impact on the balance sheet. Either on the balance sheet or in the notes, lessees must present finance lease right-of-use assets and operating lease right-of-use assets "separately from each other and from other assets."[161] Similarly, finance lease liabilities and operating lease liabilities must be presented "separately from each other and from other liabilities."[162]

3. Why Retain the Category of Operating Lease?

Because all leases must now be recorded on the balance sheet, it has not been clear whether there would be any need for a continuing distinction between a finance lease and an operating lease. Even though the IASB and the FASB were in substantial agreement throughout their reconsideration of lease accounting, the two diverged on this issue in their final reforms. The IASB's final standard for leases abandoned the finance *versus* operating lease distinction. Under IFRS, all leases must now be treated as finance leases for both balance sheet purposes and income statement purposes.[163] By contrast, we have seen that ASC 842 continues to treat operating leases differently from finance leases on the income statement.[164] The result of retaining a distinction between finance leases and operating leases is that "the effect of leases in the statement of comprehensive income and the statement of cash flows is largely unchanged from previous GAAP."[165] Operating lessees will report a single combined lease expense as part

159. ASC 842-20-25-6(a) ("unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset").

160. What is new with respect to operating leases is that the reduction in the newly recorded lease asset must be accounted for. Recall that, for the first time, an operating lease will be recorded as an asset on the balance sheet. An entry must be made that will reduce that asset over time. ASC 842 does not use the term "amortization" to refer to the reduction in the right-of-use asset in the case of an operating lease—that term is used only in connection with finance leases. *Compare* ASC 842-20-35-1(b), -2 (finance lease), *with* ASC 842-20-35-3(b) (operating lease). Instead, a reduction in the right-of-use asset is computed by deriving a deemed interest expense and deducting it from the straight-line lease expense. The deemed interest expense for the period is computed by multiplying the total current outstanding lease liability by the discount rate. In sum, the reduction of the right-of-use asset is what is left over after deducting the deemed interest expense from the rent expense. As one commentator put it, "the amortization expense is basically 'backed into.'" *Paradigm Shift*, *supra* note 85, at 4. Similarly, a lease liability has been capitalized and recorded as a liability on the balance sheet. An annual entry must be made that will reduce the lease liability to the present value of the remaining lease payments. ASC 842-20-35-3(a).

161. ASC 842-20-45-1(a).

162. ASC 842-20-45-1(b).

163. IFRS 16, *supra* note 75, at para. IN8.

164. "This divergence will cause complications for multi-national companies dealing with the different models in different jurisdictions." CATALYST, *supra* note 122, at 1.

165. ASU 2016-02, *supra* note 3, at 2.

of continuing operations. Unlike the case of a finance lease, none of the lease expense must be classified as part of the expense of financing a business.

The basic criticism of single lease expense treatment for operating leases is that it ignores the twofold economic reality behind that expense. Specifically, it fails to clarify the fact that there is implicit interest being paid with respect to the lease liability. As one study commented, it results in "obscuring the amount of effective interest expense related to the lease liability and limiting the amount of amortization reported in any given period."[166] The question then is why did the FASB pull back from the IFRS requirement that operating lessees separate the two components of lease expense on the income statement?

Most fundamentally, the FASB treated operating leases differently from finance leases because it viewed the two as substantively different. It stated that "the economics of leases can vary for a lessee and that those economics should be reflected in the financial statements."[167] A finance lease is in economic substance the purchase of the underlying asset. The lessee receives substantially all the economic benefits and burdens associated with the underlying asset. Those benefits and burdens can fluctuate in value over time, either up or down, and the lessee can depreciate the asset at a different rate than it reduces the liability. By contrast, an operating lease does not represent an acquisition of the underlying asset. Rather, an operating lease represents an acquisition of an equal right to access the underlying asset over the lease term. Generally, payment for that access is also equal over time. Therefore, the right and the liability ought to decline at the same rate over time.[168]

166. Angela Wheeler Spencer & Thomas Z. Webb, *Leases: A Review of Contemporary Academic Literature Relating to Lessees*, 29 ACCT. HORIZONS 997, 1016 (2015) [hereinafter *Academic Literature*].

167. ASU 2016-02, *supra* note 3, at 2. Another argument made to the FASB in favor of retaining the distinction was that the accounting for leases should reflect the legal definition of an asset and a liability in bankruptcy. Recall that leases in bankruptcy will be evaluated to see whether they are, in substance, mortgages as opposed to more limited contracts for the use of assets. *See* text accompanying *supra* note 129. The theory was that the accounting for leases should make the same basic distinction, given that the two kinds of leases have very different substantive economic impacts in bankruptcy. Mere operating leases "may be assets and liabilities to a going concern but not in most bankruptcy scenarios." Letter from William Bosco, to Russell Golden, Chairman, Fin. Accounting Standards Bd. & Hans Hoogervorst, Chairman, Int'l Accounting Standards Bd. 2 (July 23, 2013), http://www.leasing-101.com/c5/03BoscoCommentLetter07.23.2013.pdf (commenting on 2013 second exposure draft). Retention of the distinction between finance leases and operating leases would "provide debt analysts and lenders information about the assets available in bankruptcy and the debt that will survive bankruptcy." *Id.*

168. For some FASB members, the fundamental premise of the lessee accounting model in ASU 2016-02 is that

> operating leases are economically different from finance leases and that recognition of a generally straight-line single lease cost for operating leases appropriately reflects the fact that, in an operating lease, the lessee solely obtains a generally equal right to use the underlying asset throughout the lease term and is not exposed to, nor does it benefit from, changes in the value of the underlying asset in a way an owner of a similar asset is exposed to (or benefits from) such changes.

ASU 2016-02, *supra* note 3, at para. BC68. The "carrying value of the right-of-use asset, which reflects the remaining economic benefits of equal access to the underlying asset during the remainder of the lease term, is directly correlated to the generally equal lease payments the lessee makes for those benefits." *Id.*

Because the right-of-use asset and the lease liability are initially recorded at the present value of the rent obligation, the operating lease right-of-use asset and its corresponding lease liability are reduced each year to the present value of the remaining lease payments. For FASB members "viewing accurate measurement of the lease liability as paramount," the decision to measure the right-of-use asset by reference to the lease liability throughout the lease term "is principally one of cost benefit"[169]:

> In their view, measuring the right-of-use asset by reference to the lease liability represents the most cost-effective way to enact what they view as the primary improvement resulting from [ASU 2016-02] (that is, the recognition of the lease assets and lease liabilities that arise from operating leases) while still reflecting what they view as the economic substance of those leases in the income statement and the statement of cash flows and reasonably representing the future economic benefits to the lessee in the lease.[170]

The FASB partially addressed the issue of interest not being reported separately for operating leases by requiring lessees to disclose the weighted average discount rate for operating leases.[171] This disclosure enables readers of financial statements to calculate what interest expense would be if recognized for operating leases each period.

When the split from IFRS was finally announced, it was explained that retaining "the presentation of expenses and cash flows consistent with current GAAP" was "in direct response to U.S. stakeholder feedback to reduce costs associated with implementing" the new rules.[172] Retaining the distinction between finance leases and operating leases, along with other simplifications, would "allow many lessees to leverage their existing systems and processes to apply the requirements"[173] of the new rules:

> Companies . . . will be able to leverage many of their existing financial reporting processes, reducing costs associated with implementing [ASU 2016-02]. This is because the core guidance to determine finance and operating leases will be applied to [the new] guidance, and most of the underlying data needed to record the liability already is captured by companies to create the required footnote disclosure.[174]

The announcement concluded that because of the continuity, the costs to implement ASU 2016-02 "are not expected to be significant."[175]

However, it acknowledged that some organizations will incur increased additional costs, depending on the nature and volume of their leasing activity. In general, organizations will incur "initial costs to educate employees about how to

169. ASU 2016-02, *supra* note 3, at para. BC67.
170. *Id.*
171. ASC 842-20-50-4(g)(4); *see also* ASU 2016-02, *supra* note 3, at para. BC281(a).
172. Fin. Accounting Standards Bd., Understanding Costs and Benefits, ASU: Leases (Topic 842) 2 (Feb. 25, 2016) [hereinafter *Costs and Benefits*].
173. *Id.* at 3.
174. *Id.* at 1.
175. *Id.*

apply the new requirements" and to explain to users the effect of the changes in accounting for leases on their financial statements.[176] In addition, many organizations "may need to consider supplementary processes and controls to ensure that they capture leasing activity on the balance sheet."[177]

Others have noted a dearth of empirical studies demonstrating that significant benefits would be obtained by reporting separate interest and amortization components for operating leases.[178] To some, the cost/benefit conversation may have been framed in terms of the broader question of "the price that domestic companies and auditors would have to pay for changing their reporting language from GAAP to IFRS."[179] The business community is not of one mind on this issue. Multinational companies are already familiar with IFRS and are used to reporting under them.[180] However, at many smaller, domestically centered companies, the concept of converging GAAP with IFRS "has always been synonymous with lost time, red tape and compliance costs."[181]

F. Effective Date, Transition Rules, and Major Impacts

ASU 2016-02 provides different effective dates depending on whether a company is a public company. For public companies,[182] ASU 2016-02 is effective for fiscal years and for interim periods within those fiscal years, beginning after December 15, 2018.[183] Therefore, for a calendar-year public company, ASU 2016-022 is effective January 1, 2019.[184] In addition, upon adoption, there must be some retrospective application of the new principles, primarily with respect to the balance sheet. Prior comparative years will need to be restated because GAAP "requires the presentation of comparative balance sheets for the current and prior year as well as three years of comparative income statements."[185] For public companies on the calendar year, 2017 and 2018 must be restated to reflect the impact of ASU 2016-02. For all other organizations, the new rules are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020.[186] There-

176. *Id.* at 3.

177. *Id.*

178. *Academic Literature, supra* note 166, at 1016.

179. David M. Katz, *The Split Over Convergence*, CFO Mag. (Oct. 17, 2014), http://ww2.cfo.com/gaap-ifrs/2014/10/split-convergence/.

180. "[T]he benefits of a full-scale move to IFRS always stood to be narrowly dispersed among big multinationals." *Id.*

181. *Id.* The Governmental Accounting Standards Board has not yet finalized its new lease accounting standard, but it is expected to follow the IASB rather than the FASB and treat all leases as financing leases. *See* Joseph Sebik, *The New Lease Accounting Standard: Transition Methodologies and Considerations*, Acct. Pol'y & Prac. Rep. (BNA), May 20, 2016, at 2 [hereinafter *Transition Methodologies*].

182. A public company is any organization that is either a public business organization, a not-for-profit organization that has issued certain securities, or an employee benefit plan that furnishes financial statements to the SEC. FASB in Focus, *supra* note 72, at 3.

183. ASC 842-10-65-1(a).

184. FASB in Focus, *supra* note 72, at 3.

185. *Transition Methodologies*, *supra* note 181, at 1.

186. ASC 842-10-65-1(b); *see* FASB in Focus, *supra* note 72, at 3.

fore, for a calendar-year nonpublic company, the new rules are effective January 1, 2020.[187]

The new rules will generally apply to all contracts in place on the effective date, not merely to those that are entered into after the new rules take effect. Therefore, unless a firm avails itself of the transition relief discussed below, the new rules will apply to all of a firm's contracts. This means, first, that a firm will be required to evaluate all of its contracts to determine whether they are or contain leases. Depending on the firm, the magnitude of this task could be staggering: "The list of agreements might include but not be limited to certain product purchase or supply agreements, power purchase agreements, certain concession agreements, dedicated contract manufacturing agreements and even possible utility agreements."[188] Second, contracts that are or contain leases must be reassessed to determine whether they are to be classified as finance or operating. Third, initial direct costs would need to be reassessed.

To avoid what could be the crushing administrative burden of making these reassessments, the new rules permit firms to elect a liberal transition relief package, which ASU 2016-02 calls a "practical expedient."[189] Those that elect the transition relief package are not required to reassess whether existing contracts are or contain leases.[190] A firm will not need to reassess whether old contracts that were classified as leases are still leases. Similarly, contracts that were not leases under the old model can simply be carried forward as representing something other than leases. In addition, companies that elect the package are not required to reassess the classification of existing leases as finance *versus* operating.[191] Consider, for example, a lease that has been classified as an operating lease because it flunked by the thinnest of margins the SFAS 13 bright-line tests for capitalization. That lease can continue to be classified as an operating lease even if it would be clearly classified as a finance lease under the new rules. In addition, companies that elect the transition relief package are not required to reassess initial direct costs for existing leases under the new and more stringent direct cost standards.[192] This relief package is likely to save significant costs, particularly for firms with many contracts that are or might contain leases.[193]

Even assuming that most businesses will opt into the transition relief package, major accounting and legal firms, in-house accountants and attorneys, and other

187. Earlier adoption is permitted. A "modified retrospective" transition would be required. To make things easier, the lessee can use hindsight to determine whether, for example, it exercises renewal or purchase options.

188. *Transition Methodologies*, *supra* note 181, at 7.

189. ASC 842-10-65-1(f). The same practical expedient is available to lessors.

190. ASC 842-10-65-1(f)(1).

191. ASC 842-10-65-1(f)(2).

192. ASC 842-10-65-1(f)(3).

193. There is also a second practical expedient that allows firms to use hindsight to determine the lease term when, for example, considering whether options to extend or purchase have been exercised or declined. ASC 842-10-65-1(g). This second practical expedient may be adopted or not independent of the transition relief package.

experts are encouraging businesses to begin immediately considering what it will take to transition to the new rules.[194] The transition rules are lengthy and complex, with potentially significant costs attached, and are beyond the scope of this article.[195]

Because almost all leases must now be recorded on the balance sheet, many firms may need to report significantly more data, particularly with respect to operating leases.[196] In the past, operating lease data may have been obtained only for business purposes and not for financial accounting purposes.[197] Many firms will need new processes to support the classification and measurement of lease assets and liabilities.[198] For some, new software and systems may be required to capture, store, retrieve, manipulate, and report data for financial accounting purposes.[199] For example, new software may be necessary to perform present value and amortization calculations for virtually all leases.

In addition to the need for new software and systems, the new standard will have governance implications for public companies. Because of the significance of the new leasing standard and its potential effect on many companies with substantial lease obligations, it will be important that senior management assure that the company is properly applying it. For example, the standard will require the review and modification of a company's policies concerning internal control over financial reporting ("ICFR") to assure that the proper assessments are being made, recorded, and reviewed. In addition, the periodic certifications made regarding ICFR by the company's principal executive and financial and accounting officers will need to reflect the ICFR as so modified. Further, if the company has an audit committee financial expert, consideration should be given to whether the expert is familiar with the new leasing standard and its effect on the company.

Another reason to begin early is to assess any possible increase in the cost of credit for firms whose balance sheets make the extent of their leverage more apparent. Hopefully, the massive increase in borrowing costs and the resulting dire economic consequences predicted by the Chamber Study will not materialize. Although it appears that well over $1 trillion of fresh obligations will be recorded

194. *See New Leases Standard*, *supra* note 83.

195. *Transition Methodologies*, *supra* note 181 *passim*, is an extensive and excellent article on the transition rules.

196. *See* ASC 842-20-50-1—842-20-50-9 (other lessee qualitative and quantitative disclosure requirements).

197. "Few lessees maintain a sophisticated lease accounting system designed to handle capitalized leases and the offsetting liability treatment. Lessors may offer their support in the interim to keep the leasing volume up but, ultimately, lessees will need their own systems to better manage and account for their leases." *Paradigm Shift*, *supra* note 85, at 6.

198. "For some companies, the new lease accounting standard . . . is likely to entail significant cost and complexity. The cost of adoption is likely to include the education of all key stakeholders, robust systems upgrades, new processes, and implementation of new controls." *Perspective*, *supra* note 68, at 3.

199. *New Leases Standard*, *supra* note 83 (slide 38) (addressing the need for technology to support efficient data gathering for large volumes of leases, store lease documents and related data, and perform necessary calculations while creating required disclosures, as well as other operational considerations). *Compare Economic Impacts*, *supra* note 66 ("[T]he necessary data should already be collected if these firms have good internal control systems, particularly in light of developing fair value disclosure requirements.").

on balance sheets, the existence of those obligations is neither new nor a surprise, especially in the case of public companies. As the SEC Report and others[200] have noted, many sophisticated investors, creditors, and rating agencies had already reconstructed the balance sheets of public firms to add long-term lease obligations as liabilities. Furthermore, many lending decisions and loan covenants have been made more on the basis of the income statement than on the basis of the balance sheet. There is empirical evidence that creditors and lenders rely less on the balance sheet and more on the income statement when it comes to firms with significant amounts of operating leases.[201] To the extent that is true, recording operating leases on the balance sheet may have a less significant or even minimal impact on the cost of funds. Similarly, given the FASB's continuation of the operating lease classification for expense purposes, ratios based on the income statement of companies with multiple operating leases may be largely unaffected, whether the ratios are being used for credit decisions, to determine compliance with existing covenants, or to provide for executive compensation.

It remains to be seen whether the new leasing standard will affect the cost or availability of credit for nonpublic companies. Many credit decisions relating to nonpublic companies will still be made on the basis of income statement analysis. The important question is often whether the company's cash flow is sufficient to enable it to service its debt and other obligations. Nonpublic companies may be required to provide lenders with much more financial information than is set forth in the financial statements, including proposed budgets; projected financials, including a comparison of actuals *versus* budget; more information about receivables; and so forth. Very small or less financially sound firms may continue to find financing based on secured debt, guarantees, or other credit support.

Companies may look for ways to minimize the new lease liabilities that are recorded on the balance sheet. Some may claim that arrangements that previously might have been leases are no longer leases because the new control-the-use requirement is not met. Others may rely on the provision that contracts transferring an undivided interest in the use of assets, such as pipelines or fiber-optic cables, are not leases because they do not involve an identified asset.[202] Still others may find new incentive to disaggregate their package agreements into lease components *versus* non-lease components to avoid capitalizing payments for significant items, such as maintenance or other services, rather than for the use of an asset.[203] Some firms may consider altering their standard form contracts. For example, retailers

200. *See also Academic Literature*, *supra* note 166, at 997 ("In general, the research reports that lenders, credit rating agencies, and other capital market participants sufficiently understand off-balance sheet leases and consider them in their decision making.").

201. Daniel Gyung H. Paik et al., *The Relation Between Accounting Information in Debt Covenants and Operating Leases*, 29 Acct. Horizons 969 (2015).

202. *See* ASC 842-10-55-60.

203. *Paradigm Shift*, *supra* note 85, at 6 ("Previously bundled elements will be broken out into separate components or those elements may be billed separately. Lessees may now request that certain items that were previously included in the cost of an asset, such as a long-term warranty or maintenance agreement, be billed on an as-incurred basis rather than included upfront so as to minimize the capitalized value.").

with many operating leases, or even professional service firms with many locations, may consider whether to rent for shorter periods[204] or opt for more variable rent and less fixed rent to reduce the amount of rent that must be capitalized.[205] Perhaps the venerable long-term, triple-net lease will itself be reconsidered in some situations. The loss of favorable balance sheet treatment for operating leases may cause some firms to consider whether the scale has been tipped so far that yesterday's lease should be tomorrow's purchase. Each of these possible contract changes will have to be evaluated from both an operational and a financial standpoint to consider potential benefits and costs.

All firms should consider the impact of the new rules on their operating results, their performance and debt coverage metrics,[206] and their debt covenants. Throughout the project, there has been particular concern about the impact on debt covenants.[207] Indeed, the FASB has said that the long lead time between issuance and implementation was intended to "mitigate concerns raised about potential debt covenant violations."[208]

Most of the concern about debt covenants seems to have been about covenants based on the balance sheet rather than on the income statement. Many borrowers have covenants providing that it is an event of a default, or an event that requires additional steps to be taken, if debt recorded on the balance sheet exceeds a certain amount or ratio. The specific language of a debt covenant can be critical. Perhaps the most basic question about existing covenants is, "Which GAAP controls?" If a debt covenant is explicitly based on GAAP as it existed at the time the covenant was entered into, the fresh liability from operating leases may not breach or trigger the covenant. If, however, a covenant does not refer to GAAP as of a particular point in time, it may be subject to interpretation or require renegotiation. For example, should liabilities attributable to operating leases be considered debt within the meaning of an existing covenant?[209] Many indentures

204. If a shorter term is accompanied by renewal options, periods covered by options the lessee is reasonably certain to exercise must be added to the lease term. ASC 842-10-30-1(a); *see also Paradigm Shift*, *supra* note 85, at 5 ("Lessors may seek residual value guarantees from lessees to compensate for additional lessor risk associated with shorter lease terms, but lessees will have to include any portion of the guaranteed amounts that are probable of being paid in lease payments (and thus capitalize that portion).").

205. Variable lease payments that do not depend on an index or rate are not lease payments that must be capitalized. ASC 842-10-30-6(a).

206. *See* Catalyst, *supra* note 122, at 4 ("While the dual model may often limit the impact on income-based performance metrics, it may impact other financial metrics that utilize balance sheet elements, for example, debt-to-equity ratios or return on assets metrics. Further, there may be indirect impacts caused by these changes. For example, recording significant additional assets may affect state tax payments, while changes to key metrics may alter incentive compensation payments or earnouts and perhaps even impact legal or regulatory capital.").

207. Firms may also opt to apply the new standard early. ASC 842-10-65-1(b).

208. *See Costs and Benefits*, *supra* note 172, at 3; *see also* Clifford W. Smith, Jr., *A Perspective on Accounting-Based Debt Covenant Violations*, 68 Acct. Rev. 289, 292 (1993) ("The longer the time from an initial discussion memorandum to final implementation, the more time firms will have to adjust and the less likely the changes will result in technical default."). The author notes that lenders have incentive to renegotiate contracts: "For the lender, maintaining a reputation for eschewing opportunistic behavior is important in attracting future borrowers . . . ." *Id.*

209. Some covenants treat off-balance sheet leases as debt. Lipe Review, *supra* note 60, at 5.

and credit agreements make clear that indebtedness relates to money borrowed and not to lease obligations. However, even if the distinction was not explicit, lease obligations may not have been intended to be included at the time the covenant was made. The different nature of operating lease liabilities is underscored by their separate treatment under the new standard. They must be stated separately on the balance sheet and treated differently on the income statement. Similar issues can arise with respect to executive compensation agreements.

V. Conclusions

ASU 2016-02 clearly advances the purpose of SOX to address off-balance sheet financing. It does so by requiring that most leases, including operating leases, be reported on the balance sheet. The new rules on balance sheet inclusion no longer focus on whether a lessee has substantially all the benefits and burdens of the underlying asset. Rather, the focus is on the leasehold interest itself. Any contract that is in substance a lease for more than twelve months must be capitalized and recorded on the balance sheet as both an asset and a liability. The asset is called a right-of-use asset, and the lease liability is the obligation to pay rent for the entire term. Both the asset and the liability must be recorded on the balance sheet at an amount equal to the present value of the future rent payments. However, the distinction between a finance lease and an operating lease continues for purposes of the income statement. The two also must be presented separately on the balance sheet.

The Chamber Study predicted that the greater apparent leverage will increase borrowing and credit costs for many firms and cause them to divert monies away from productive use and toward deleveraging. However, the SEC Report, the Lipe Review, and others have made the point that sophisticated creditors, investors, and rating agencies had already used financial models that effectively reconstructed the balance sheets of public firms to reflect lease liabilities. There also is empirical evidence that investors and creditors often evaluated firms with many leases more on the basis of the income statement than on the basis of the balance sheet. Moreover, it has been clear for years that the final result was going to be lease capitalization on the balance sheet. Depending on the firm, there are two or three additional years before the rules take effect. Most sophisticated firms should have had ample time to adjust to any new balance sheet presentation. Time and empirical study will tell the extent to which some firms will indeed incur increased lender, creditor, or investor demands because the extent of their leverage is now more readily apparent. The biggest increase in the cost of funds may be felt by smaller firms whose creditors or investors previously made decisions on the basis of unreconstructed balance sheets.

The new rules may impose other significant costs on firms. Even firms that opt into the transition relief package should begin immediately to assess the extent to which operating systems may have to be redesigned and new technology deployed to collect, assess, and manipulate data, including the calculation of the present value of every lease. There may also be other significant economic or

legal consequences. The impact is likely to be felt more by some firms than others, particularly by those with many operating leases. Depending on the industry, firms may consider whether to structure their contracts differently to avoid lease classification or to minimize the amount that must be capitalized and reported on the balance sheet. Some real estate leases, for example, may become shorter or may be based more on contingent rent than on fixed rent. All firms should consider the impact of the new rules on their performance and debt coverage metrics, including the extent to which they affect their ability to obtain financing, their debt covenants, and their executive compensation agreements. Some also may need to address internal or regulatory controls.

Costs aside, the new rules reflect and reinforce the trend away from formalism and toward economic substance. Despite the divergence on expense treatment for operating leases, the new rules reflect a further shift away from a rules-based approach and toward the IASB's principles-based approach.[210] The formalistic tests of SFAS 13 enabled gaming the rules to the knife's edge. The new rules are written without bright lines and are intended to discourage a formalistic approach. They ask companies to use judgment[211] to prepare financial statements based on economic reality. Throughout, they apply a totality-of-the-circumstances approach that considers the full range of economic realities. Repeatedly, firms are asked to assess "all economic factors," including those that are "contract-based, asset-based, market-based and entity-based."[212] The shift away from formalism and toward practical economic reality is intended to encourage more meaningful reporting in basic financial statements and beyond.

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210. *Cf.* U.S. SEC. & EXCH. COMM'N, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM (2003), https://www.sec.gov/news/studies/principlesbasedstand.htm#1a.

211. Not everyone is pleased about converging with standards that rely more on judgment. *See* Letter of Sen. Carl Levin to Russell G. Golden, Chairman, Fin. Accounting Standards Bd. 2 (Oct. 14, 2014) ("Finance executives and corporate accountants will have to, and will be encouraged to, use their judgment much more than they've ever had to before. Given competitive pressures and the history of accounting abuses over the last two decades, greater reliance on management judgment to ensure proper accounting disclosures does not build confidence."). Senator Levin was discussing the newly converged revenue recognition standards in Fin. Accounting Standards Bd., Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers (Topic 606) (May 28, 2014), which ASU 2016-02 reflected. *But see* Adoria Lim & Chi Cheng, *How Principles-Based Accounting Standards Impact Litigation*, LAW360.COM (Feb. 22, 2016), https://www.law360.com/articles/760089/how-principles-based-accounting-standards-impact-litigation ("With regard to *leasing* specifically, research has generally found that a move from rules-based standards toward principles-based standards results in less aggressive reporting, perhaps for fear of litigation."). The authors also report, however, that research outside the area of lease accounting is mixed. *Id.* at 3. They also report some evidence that "mock juries return fewer verdicts against auditors in a principles-based regime," while noting a dearth of research regarding hypothetical verdicts against companies or their directors and officers. *Id.* at 4.

212. *See* ASC 842-10-55-26.