BY MATTHEW C. BOCH AND JAMES H. WILLIAMS, III

New Lease Accounting Standards Can Quantify Investment for Economic Development Incentives Purposes

New accounting standards for leases generally require lessees of business assets to create right-of-use assets and offsetting liabilities instead of just expensing lease payments. Businesses seeking or complying with incentives may find this new accounting treatment useful because the amount of the right-of-use asset provides a principled way to quantify upfront the investment impact of a lease.

This new approach will not be universally applicable for incentives; many incentive programs have existing rules in place for recognizing as investment either lease payments when paid or lessor investments caused by the lessee. Additionally, right-of-use lease assets pose a risk of subsequent downward adjustments that could trigger clawbacks. Nonetheless, in situations where what constitutes "investment" is not defined by law, this right-of-use asset approach is potentially a useful tool for businesses negotiating awards or facing potential investment shortfalls under other methodologies.

The problem: what is a lessee's "investment" in a project? Anyone who has been involved in incentives compliance recognizes the definitional complexity in calculating the "new jobs" and "new investment" of a project. Calculating investment where the business is leasing property, not building or buying it, poses a particular problem because the new or expanding business is not making the upfront expenditure. At the same time, however, the long-term commitment of a business under a lease can allow the lessor to buy, build, or improve the property being leased—providing real and beneficial economic activity (including job creation) that in many cases occurs before most of the lease payments have been made.

Jurisdictions vary in their approaches to determining lessee investment for incentives purposes.

- Lease payments sometimes count as investment on a pay-as-you-go basis. Businesses can count lease payments when (and only when) they are made. However this approach can be problematic because it tends to delay when the investment is recognized for incentive performance purposes. The new factory or office building may be up and running in months, whereas the lease payments may stretch over decades.
- The alternative to counting lease payments has been to look through and count the lessor's expenditures as the lessee's investment. So if the lessor is renovating a facility, the lessee would count the lessor's renovation costs. This approach has two problems. First, it does not count the economic value associated with productive use of existing property. Second, the practical reality of a lessee getting accounting information from the lessor can be a challenge; the lessor does not want the lessee to be able to see its costs and infer its profits. Changes in financial accounting for leases now offer a potential third way of determining the investment associated with leasing property.

New accounting standards require lessees to recognize "right-of-use" assets. In February 2016, the Financial Accounting Standards Board updated its standards for lease accounting.[1] The core of the change is that lessees are now required to recognize the assets and liabilities associated with leases. This contrasts with the prior practice of recognizing operating lease payments with respect to non-financing leases in the period when payment is made. Going forward, "[a] lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term."[2]

The initial measurement of the right-of-use asset at the commencement date of the lease is basically the value of the future lease payments. Specifically, it consists of the following:

- The amount of the initial measurement of the lease liability;
- Any lease payments made to the lessor at or before the commencement date, minus any lease incentives received; and
- Any initial direct costs incurred by the lessee.[3]

A discount rate is used to calculate the present value of the future lease payments.[4] In determining the term of the lease for calculating the asset (and liability), lessor options to extend the lease are treated as exercised.[5] Lessee options to extend the

MATTHEW C. BOCH is a member of the Little Rock, Arkansas, law firm of Dover Dixon Horne PLLC. JAMES H. WILLIAMS, III is a Senior Tax Adviser and Consultant at Frost, PLLC in Little Rock, Arkansas.

lease or to cancel the lease are treated as exercised if the extension or cancellation is "reasonably certain" to be exercised.[6]

The ultimate result of these rules is that as of the commencement date of the lease (generally when the lessor makes the asset available for use by the lessee[7]), a right-of-use asset is created based on the discounted value of future lease payments.

The new accounting treatment of leases is required for public companies for fiscal years beginning after December 15, 2018, and for private companies for fiscal years beginning after December 15, 2019.[8] Companies are permitted to begin adopting the new rules immediately.[9]

Right-of-use assets offer a way of measuring lessees' investments in projects. This new way of accounting for leases may be a useful tool for quantifying investment for incentives compliance and reporting. The right-of-use asset for leased property reflects the lessee's economic commitment to the jurisdiction. A lessee business may be able to report this asset as investment for a project that is receiving economic development incentives, depending on the legal framework of the incentive and the approach taken by the economic development authority's compliance staff.

The right-of-use asset approach may offer benefits when compared with other ways of calculating lessee investment:

- Unlike a pay-as-you-go approach, recognizing the value of the lease upfront can reflect how the initial commitment to future lease payments induces economic activity in the jurisdiction. Particularly where there is a time threshold for making the incentivized investments, recognizing the value of the lease commitment upfront may be beneficial. (However, if a business needs to meet a long-term nominal investment dollar amount, then the discounting under the new lease accounting standards may be disadvantageous versus a pay-as-you-go approach that does not discount future lease payments.)
- When compared with the approach of looking through to lessor investments and expenses, the right-of-use asset approach often makes more sense insofar as it reflects the economic impact of the lessee's leasing activity. In contrast, a lessor expense approach may present difficulties regarding determination of investments made by a lessor in the past. Additionally, focusing on the lessee's right-of-use asset avoids the logistical difficulty of requesting lessor accounting records.

Businesses seeking or complying with incentives may find this new accounting treatment [for leases] useful.

While the right-of-use asset approach can offer many advantages in calculating lessee investment, it may not always be allowed by the law governing the particular incentive. If a statute or regulation specifically addresses how to calculate lessee investments, then such legal requirements likely control over financial accounting treatment.

Additionally, even if there is no legal prohibition, some agencies handling economic development incentive compliance may be uncomfortable with the right-of-use asset approach as differing from current practice, and particularly since there is little or no cash outlay by the lessee when the asset is created. Inevitably, there will be a learning process at the agency level where the new accounting treatment may be accepted for some purposes but not others. Indeed, in clawback disputes where investment is at issue, this right-of-use asset approach could be a strong argument for a business seeking to avoid penalties.

Lease modifications, asset remeasurement, and risk of clawbacks. A risk of using right-of-use assets to measure lessee investment is that the lease could be modified or the situation changed such that the right-of-use asset needs to be adjusted. The accounting standards provide for reassessment of the lease term or remeasurement of lease payments upon certain events and contingencies.[10] These can increase or diminish the value of the right-of-use asset.

Such an instance occurs in Example 18 of the accounting standard, where the lessee and lessor agree to halve the amount of office space being leased midway through a 10-year lease, and to reduce the lease payments accordingly.[11] That modification results in a reduction of the amount of the right-of-use asset.[12]

If a right-of-use asset has been claimed as investment under an incentive program, then such subsequent adjustments may need to be taken into account in measuring the performance of the business. If the company expands its economic commitments in a jurisdiction and adjusts the asset upward, that should count toward its performance.

On the other hand, if the asset is adjusted downward, as in the case of Example 18, that subtraction could take the company below investment thresholds and raise the possibility of clawbacks. An incentive agreement using the right-of-use asset approach may need a mechanism to take such potential subsequent adjustments into account.

Conclusion. In many instances, businesses leasing property will be well served to utilize such leased property right-of-use assets as a way of quantifying project investment for economic development incentive reporting purposes. These right-of-use asset amounts will be readily available since they will be used for financial accounting purposes. In many instances, the tendency of this approach to result in large upfront investment amounts will be beneficial for incentives compliance purposes.

Businesses should, however, bear in mind that the right-of-use asset approach may not be allowed under the law and guidance for some incentive programs, that the computational mechanics may make it harder to hit nominal dollar investment targets, and that there is a risk of downward adjustments to right-of-use assets that could trigger clawbacks.■

1 Accounting Standards Update 2016-02, Leases (Topic 842) (Feb. 2016), available at http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176167901010.

2 Update 2016-02 at 3.

3 Update 2016-02 at 103, Accounting Standards Codification ("ASC") 842-20-30-5.

4 Update 2016-02 at 103, ASC 842-20-30-2, 842-20-30-3 (requiring use of the rate implicit in the lease, or, if such rate is not readily determinable, the lessee's incremental borrowing rate).

5 Update 2016-02 at 34, ASC 842-10-30-1.

6 *Id.*

7 Update 2016-02 at 43, ASC 842-10-55-19.

8 Update 2016-02 at 7.

9 *Id.*

10 *See* Update 2016-02 at 36-37, ASC 842-10-35-1–842-10-35-5.

11 Update 2016-02 at 72-73, ASC 842-10-55-177–842-10-55-180.

12 Update 2016-02 at 73-74, ASC 842-10-55-181–842-10-55-185. Two methods of remeasuring the right-of-use asset are provided.