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Current Valuation Issues

FASB/IASB PROPOSED ACCOUNTING STANDARDS UPDATE

Leases (Topic 840)

Industry Focus: Media, Entertainment and Communications

Overview

The Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") are developing new standards on the financial reporting for leases which will have a profound effect on both lessees and lessors.

As a general matter, lessees will be required to establish an asset and a corresponding liability for leases, in contrast to the current practice in which most leases were simply accounted for as an operating expense. For the time-being, leases of intangible assets are not part of the proposed standards.

The impact on media and communications companies could be substantial, particularly for those with a significant number of tower site leases. There are over 125,000 communications towers in the United States in addition to approximately 3,000 broadcasting towers, most of which have at least one tenant. Many towers, particularly the tall structures used for broadcasting, can have over a dozen television, radio, wireless telecom, business radio, and microwave tenants. The largest companies in the tower industry, such as American Tower and Crown Castle, manage between 20,000 and 25,000 communications towers, broadcast towers, rooftops, distributed antenna systems, and similar facilities. Conversely, the largest wireless carriers maintain tens of thousands of leased tower and retail facilities nationwide. Diversified broadcasters typically require fewer sites, but pay substantially more for higher antennas and heavier equipment loading. Compliance with the new requirements will be a massive and complex undertaking for these companies.

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Background

On August 17, 2010, the FASB and the IASB published an Exposure Draft ("ED") on the subject of Leases (Topic 840), with a Comments Due date of December 15, 2010. The ED was developed in response to mounting criticisms of existing lease reporting standards "because they do not provide a faithful representation of leasing transactions. In particular, they omit relevant information about rights and obligations that meet the definitions of assets and liabilities in the board's conceptual framework."[1] The use of leases as "off balance sheet financing" that did not provide a full picture of a company's assets and liabilities is viewed as misleading to some. This concern stems from the reporting of operating leases in the financial statements of lessees, which does not currently reveal significant future liabilities. To promote symmetry, the FASB and the IASB are advocating changes to both lessor and lessee reporting.

The ED generated considerable controversy. The FASB and the IASB held four roundtables and 15 workshops around the globe and received over 750 comment letters, half from North America and half from other continents. Most comments were from financial statement preparers, although virtually all industries were represented with an emphasis on those which participate heavily in the leasing ecosystem, such as financial services, retail, real estate, and transportation.

While most respondents support the concept of increased transparency in lease accounting, there were numerous concerns regarding the complexity of the new standards and the extent to which they might actually affect economic (i.e. buy v. lease) decisionmaking. One trade group noted that the proposals could have significant consequences for investment and lending decisions by affecting the calculation of common financial ratios and their resulting impact on loan covenants.[2]

On November 1, 2011, the FASB and the IASB released modifications to the original ED and indicated that a revised ED was being prepared for release during the first half of 2012. The new requirements would not likely become effective until 2015, but would be retroactively applicable to 2013 and 2014, so it would benefit media and communications companies to begin planning for the implementation and impact of the proposed changes.

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1 Financial Accounting Standards Board, File Reference No. 18520-100, Exposure Draft: *Leases,* August 17, 2010, p. 1.

2 American Automotive Leasing Association, et. al., letter to FASB and IASB, December 10, 2010.

Some insights as to what might be contained in the "re-exposure draft" can be garnered from the decisions and tentative decisions that were reached at the November 1 meeting. The provisions are extremely complex and include the following:

Decisions Reached at the November 1 meeting include:

Lessor Disclosures

Lessors must now disclose:

1. A table of all lease-related income items disaggregated into profit, interest income on the lease receivable, interest income on the residual asset, variable lease income, and short-term lease income.
2. Information about the basis and terms of variable lease payments.
3. Information about options, such as renewal and termination options.
4. A qualitative description of purchase options.
5. A maturity analysis of the undiscounted cash flows that are included in the right to receive lease payments.

Tentative decisions reached at the November 1 meeting include:

Right-of-Use Model

The use of a Right-of-Use Model was affirmed by the FASB and the IASB. This will require a lessee to recognize a "Right-of-Use" asset which corresponds to the right to utilize the asset being leased and a corresponding liability for the associated likely future payments. These requirements apply to any arrangement which fits the definition of a lease. This is applicable for all lessee and lessor leases, except leases of real estate investment property.

Definition of a Lease

A lease is defined as "a contract in which the right to use a specified asset ("the underlying asset") is conveyed, for a period of time, in exchange for consideration." The tentative decision specifies that "a capacity portion of a larger asset that is not physically distinct (for example, a capacity portion of a pipeline) is not a specified asset." This provision could have implications for Internet and programming distribution through fiberoptic and coaxial cable leases.

In some cases, a contract may include lease and non-lease components (such as services or executory costs). In these cases, both the lessor and the lessee will be required to account for lease and non-lease components separately.

Scope

Of particular relevance to media, entertainment, and communications companies, leases of intangible assets are not covered by the proposed standards, which appear to relieve the burden on spectrum leases, time brokerage agreements ("TBAs"), local marketing agreements ("LMAs"), shared services agreements ("SSAs"), and the like. Also excluded are leases for the right to explore for minerals, leases of biological assets (such as timber) for U.S. GAAP, and leases of concession services (under IFRS).

Likely to be included are Right-of-Use assets in a sublease, leases of non-core assets, and long-term leases of land. This scope may be of particular relevance to broadcasters and communications companies with long-term leases for antenna towers on public land and other facilities, whether they are the lessor or the lessee. Similarly, cable companies will need to evaluate the applicability of pole, conduit, and riser leases.

The staff is still studying the applicability of the proposals for internal-use software.

It is also likely that short-term (12 months or less) leases will continue to be treated as operating leases and not be placed on the balance sheet.

Sale/Leaseback Considerations

Sale/leaseback arrangements which had formerly been treated as a capital asset would likely not be affected, although such arrangements which had been treated as operating leases would be reevaluated based upon the criteria for a change in control.

Lessee Accounting

Lessees will now employ only one accounting approach (rather than electing either capital lease or operating lease treatment). This will include recognizing a right-of-use asset on one side, and a liability to make lease payments on the other. The Right-of-Use asset will be systematically amortized based upon expected future consumption. The liability will be re-measured using the effective interest method in future reporting periods.

Lessor Accounting

The lessor will recognize an underlying asset and recognize income over the lease term. The asset will consist of a right to receive the present value of the lease income stream plus a provision for the residual value of the underlying asset,

initially measured as an allocation of its carrying value. The gross residual would be re-measured in subsequent reporting periods.

If, for example, a company had an asset on the balance sheet which became subject to a lease, it would establish an account receivable for the projected income stream. This amount would be "derecognized" from the original asset, and only the residual amount would become a separate asset.

Leveraged Leases

Lessors would report leveraged leases the same as other leases under the new guidelines.

Subleases

A master lease and a sublease would be treated as separate transactions.

Lease Term

The lease term is defined for both lessees and lessors as, "The non-cancellable period…together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option…" As a consequence, a degree of judgment may be necessary in determining the useful life of the lease.

Lessee Subsequent Measurement Issues

A gain or loss can be taken as they relate to foreign exchange fluctuations, and impairment must be tested periodically consistent with ASC 350.

Lessor Subsequent Measurement Issues

Lessors must consider impairment both in terms of the financial instruments provision of the income stream (IAS 39 regarding Financial Instruments and ASC 310 regarding receivables), as well as the impairment of the residual asset (IAS 36 regarding Impairment of Assets and ASC 360 regarding Property, Plant and Equipment). Typically, these must be performed annually.

There are additional provisions related to variable lease payments (e.g. dollars per unit produced from the property), contract modifications, embedded derivatives, residual value guarantees, presentation and disclosures, discount rates, and other factors which go beyond the scope of this brief overview.

Example

Presented below is a simple example of how the proposed changes might affect a media company that leases a microwave site. Amounts have been rounded for simplicity. The four year lease stipulates a payment of $25,000 per year for a total of $100,000. Using the company's 6.0% borrowing rate, the present value of the lease payments is $89,000.

Under the current reporting requirements, the company would simply report an expense each year as follows:

	Year 1	Year 2	Year 3	Year 4
Lease Expense	$25,000	$25,000	$25,000	$25,000

Under the proposed regulations, it would post an asset at the beginning of the lease term equal to the present value of the payments, and amortize that asset over time. It would also have to recognize an interest expense at its cost of debt:

	Year 1	Year 2	Year 3	Year 4
Right-to-Use Asset Beginning Balance	$89,000	$67,000	$45,000	$22,000
Amortization of Right-to-Use Asset	22,000	22,000	22,000	22,000
Right-to-Use Asset Ending Balance	$67,000	$45,000	$22,000	$0
Interest Expense	$5,000	$3,000	$2,000	$1,000
Total Expense	$27,000	$26,000	$24,000	$23,000

In this case, the company would be required to recognize higher expenses in the first two years of the lease and lower expenses toward the end:

	Year 1	Year 2	Year 3	Year 4
Lease Expenses – Existing Standards	$25,000	$25,000	$25,000	$25,000
Lease Expenses – Proposed Standards	27,000	26,000	24,000	23,000
Higher (Lower) Expenses from Proposed Standard	$2,000	$1,000	($1,000)	($2,000)

A salient result, however, is that the lessee would post a liability equivalent to the present value of the lease payments. This would be amortized over time by the difference between the total payment and the calculated "interest" rate. In other words, the treatment of the lease is now akin to a loan.

	Year 1	Year 2	Year 3	Year 4
Beginning Lease Payable Liability	$89,000	$69,000	$47,000	$24,000
Difference between Cash Payment and Interest	20,000	22,000	23,000	24,000
Ending Lease Payable Liability	69,000	47,000	24,000	$0

In short, the company would post an additional liability of $89,000 in Year 1 which could potentially have an impact upon numerous performance ratios and covenant metrics.

Conclusion

The FASB and the IASB are likely to deliver a revised ED regarding lease accounting in early 2012. At some point thereafter, new procedures will become codified that will provide a higher degree of transparency and consistency to lease accounting.

The proposed provisions will also impose new and complex burdens on media, entertainment, and communications companies. While the intangible asset exclusions provide a degree of relief, the initial reporting for leases, particularly for lessees, will be much more complex and require the establishment of balance sheet assets and liabilities. There will also be re-measurement provisions related to market changes and in connection with periodic impairment valuation requirements.

Companies in the media, entertainment, and communications sectors should study the proposals carefully and begin to consider both the costs of implementation and the impact that they may have on their financial reporting, compliance with loan covenants, and annual impairment testing.

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