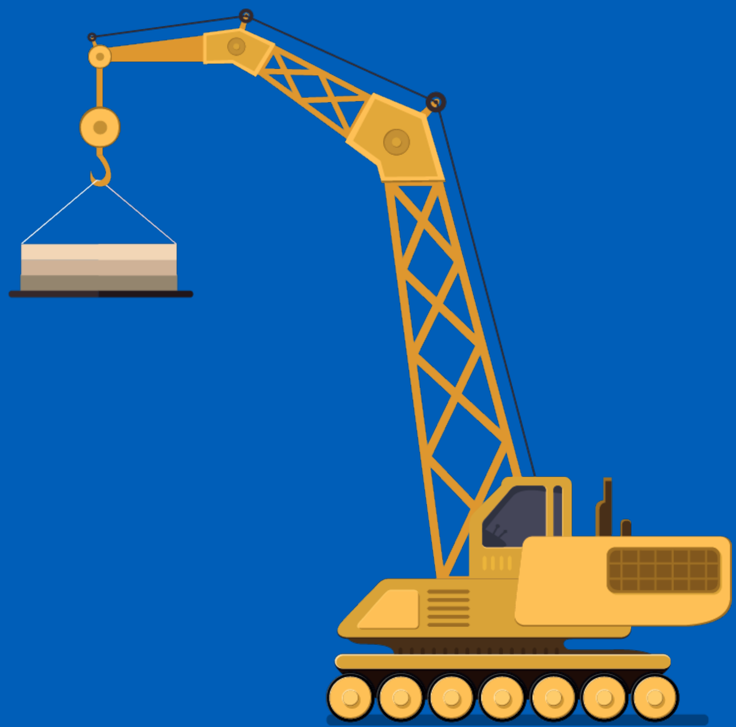
Build-to-suit leases

Issues In-Depth



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Navigating substantially different accounting

The FASB's new lease accounting standard (Topic 842) will usher in widespread changes to the accounting for leases, particularly for lessees. One of the areas that will change significantly is how lessees account for 'build-to-suit' lease arrangements. Topic 842 changes how lessees:

- assess whether they are the accounting owner of the underlying asset in build-to-suit lease arrangements under Topic 842, which differs substantially from that assessment under current US GAAP; and
- evaluate whether a sale and leaseback occurs at the end of the asset construction period.

Topic 842 will generally permit, and frequently *require*, lessees with build-to-suit assets and liabilities recognized under current US GAAP to derecognize those assets and liabilities in transition, which may significantly affect certain historical balance sheet metrics and ratios and lessees' future accounting.

Given the transition provisions, it is not surprising that some companies are considering early adoption. In this edition of *Issues In-Depth*, which supplements our April 2016 Issues In-Depth on Topic 842, we provide additional information to help lessees assess whether they are the accounting owner of an asset under construction. We also provide detailed information about the transition provisions for build-to-suit lease arrangements.

Our discussion of the build-to-suit transition provisions includes detailed flowcharts and analysis of a variety of potential scenarios in which lessees with these arrangements may find themselves as they prepare to implement Topic 842.

We trust this edition of Issues In-Depth will enhance your understanding and assist you in your ongoing efforts to implement this substantially changed lease accounting guidance.

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Current US GAAP requirements

A build-to-suit lease is a contractual arrangement that requires the developer to construct an asset based on the lessee's specifications that the lessee will lease when construction is complete. The developer finances the construction, retains ownership, and then leases the asset to the lessee at completion.

While most build-to-suit projects involve real estate, build-to-suit guidance applies to all asset construction projects with lessee involvement.

Is the lessee the accounting owner?

Under current US GAAP, a lessee involved in the construction or design of an asset before lease commencement is the accounting owner during the construction period if it either: [840-40-55-2 – 55-16]

— takes on substantially all of the construction-period risks, determined through a 'maximum guarantee test'; or

— engages in one or more specifically prohibited activities, such as directly funding construction costs, making in-substance equity investments in the project, providing prohibited indemnifications, or taking title to the asset or land on which the asset is built.

A lessee who is the accounting owner of a construction project recognizes a construction-in-progress asset on its balance sheet with a corresponding liability for construction costs funded by the lessor. When construction is complete and the lease term begins, the lessee evaluates the transaction as a sale-leaseback transaction.

If the transaction **qualifies as a sale** based on the sale-leaseback guidance, the lessee derecognizes the construction asset and recognizes profit or loss in the same manner as it would for other sale-leaseback transactions.

If the transaction **does not qualify as a sale** based on the sale-leaseback guidance, the lessee continues to report the constructed asset and any asset funding from the lessor on its balance sheet. Once the asset is in service, the lessee begins depreciating the asset in the same manner as its owned property, plant and equipment. It accounts for the lease payments as debt service payments towards the asset funding liability. For many lessees, build-to-suit assets and liabilities remain on their balance sheets long after construction is complete because the transaction fails to qualify for sale-leaseback accounting.

New build-to-suit guidance

Is the lessee the accounting owner of an asset under construction?

In contrast to current US GAAP, the new lease accounting standard (Topic 842) focuses on whether the lessee controls the underlying asset before the lease commencement date when the asset is under construction. Topic 842 does not consider exposure to construction period risks, nor does it explicitly prohibit certain activities. However, it does state that any one of the following characteristics would demonstrate that the lessee controls the underlying asset before the lease commencement date. [842-40-55-5]

- The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (e.g. by making a payment to the lessor).
- The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use to the owner-lessor.
- The lessee legally owns both the land and the property improvements that are under construction, or the non-real estate asset that is being constructed (e.g. a ship or aircraft).
- The lessee controls the land on which the property improvements will be constructed (which includes where the lessee transfers the land to the owner-lessor, but that transfer does not qualify as a sale – e.g. because of a lessee repurchase option) and does not enter into a lease of the land prior to the beginning of the construction that, together with the renewal options[1], permits the lessor or another related party to lease the land for substantially all of the economic life of the property improvements.
- The lessee is leasing the land on which the property improvements will be constructed, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements and does not enter into a sublease of the land prior to the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

Note 1:

'Options' refers to all renewal options, regardless of whether it is reasonably certain that those options will be exercised. In other words, this criterion considers the maximum possible lease term, rather than the 'lease term' as defined in Topic 842.

This list is not exhaustive. There may be other factors or circumstances that demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

Section 9.4.1 of our April 2016 Issues In-Depth provides some examples that show how to apply the new guidance to determine whether a lessee controls an underlying asset that is under construction before the commencement date.

KPMG observation:
Lessee ownership of assets under construction

Because Topic 842 changes the underlying principle to determine when a lessee is the accounting owner of an asset under construction, we expect there will be some different accounting outcomes compared with current US GAAP.

Control evaluation

The FASB observed that conceptually the evaluation of whether a lessee controls an underlying asset under construction is similar to the evaluation made under the new revenue recognition standard to determine whether a performance obligation is satisfied over time.

The revenue guidance says that a customer obtains control of a good as it is being produced (or modified), and the entity satisfies its performance obligation to transfer that good over time when either or both: [606-10-25-27]

- the entity's performance creates or enhances an asset (e.g. work-in-process) that the customer controls as the asset is created or enhanced; or
- the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

We believe it was the Board's view that the evaluation of whether a lessee controls an asset under construction should be similar to evaluating whether a customer controls an asset during construction that it will own after construction ends. [ASU 2016-02.BC400(b)]

Contingent call options

A call option on the underlying asset under construction does not have to be unconditional to confer control of the asset to the lessee. A call option that is contingent on an event *within the lessee's control* – e.g. the contingent event is a default on the construction timeline and lessee is the construction manager – would also confer control of the underlying asset to the lessee.

Call options that do not exist throughout the construction period

A lessee call option that would confer control of the underlying asset to the lessee may not be exercisable at the beginning of the construction period, but may become exercisable during construction. If so, the lessee becomes the accounting owner of the asset at the point in time the option becomes exercisable.

Conversely, a lessee call option that confers control of the underlying asset to the lessee could expire before the end of the construction period. The lessee would still account for the arrangement as a sale-leaseback transaction at the end of the construction period when the leaseback commences.

Lessor put options

While the guidance only refers to lessee call options conferring the control of the underlying asset to the lessee, we believe control would also be conferred to the lessee if the lessor has a 'significant economic incentive' to exercise a put option – i.e. an option to force the lessee to purchase the underlying asset under construction. Our view is based on the repurchase agreements guidance in the new revenue recognition standard, which states that the seller of a good retains control of that good if the customer has a significant economic incentive to exercise an option to return the good to the seller. [606-10-55-72]

Other factors or circumstances

The new guidance states that there may be 'other factors or circumstances', beyond those listed, that demonstrate that a lessee controls an underlying asset that is under construction. At present, it is unclear what those other factors or circumstances would be, because none have been identified in practice. It is our understanding that the Board and the staff did not have any specific other factors or circumstances in mind when drafting the guidance. However, lessees should keep the control principle from the new revenue recognition standard in mind – i.e. the ability to direct the use of, and obtain substantially all the remaining benefits from, an asset – when considering whether they control an underlying asset under construction.

Lessee accounting owner recognizes asset and liability

The accounting by a lessee that is the accounting owner of an asset under construction is substantially the same as current US GAAP. However, because Topic 842 significantly changes the sale-leaseback guidance, fewer sale-leaseback transactions involving build-to-suit real estate will result in failed sales. Consequently, there are fewer factors that would keep lessees from derecognizing build-to-suit assets and liabilities at the end of the asset construction period. Section 9.1 of our April 2016 Issues In-Depth provides additional information about the changes to sale-leaseback accounting.

Transition for existing build-to-suit arrangements

Evaluating previous build-to-suit conclusions

A lessee is not required to reevaluate whether it would have been the accounting owner of an asset under construction in accordance with Topic 842 unless construction of the asset is in progress at the effective date. This is the case regardless of whether the lessee was or was not the accounting owner of the asset under current US GAAP. [842-40-55-5]

If a lessee is determined to be the accounting owner of an asset under construction as of the effective date for which it **was not the accounting owner** under current US GAAP, it will recognize the assets and liabilities arising from being the accounting owner of an asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it becomes the accounting owner of the asset under construction based on the guidance in Topic 842. The lessee would account for the assets after the effective date using the Topic 842 sale-leaseback guidance.

Derecognition of build-to-suit assets and liabilities

The transition guidance in Topic 842 requires lessees to derecognize any assets (e.g. property, plant and equipment or construction-in-progress) and liabilities recorded solely as a result of being the accounting owner of a construction project under current US GAAP unless both: [842-10-65-1(u)]

- construction of the asset is in progress at the effective date of Topic 842; and
- the lessee is the accounting owner of the underlying asset under construction based on Topic 842.

A lessee derecognizes existing build-to-suit assets and liabilities at the later of the: [842-10-65-1(u)]

- beginning of the earliest period presented; or
- date the lessee was determined to be the accounting owner of the asset under current US GAAP.

Any difference between the assets and liabilities derecognized is recorded to equity on that date.

Derecognition of the existing build-to-suit assets and liabilities would occur in accordance with the preceding paragraphs regardless of whether the transaction qualified as a sale-leaseback transaction under current US GAAP.

Build-to-suit arrangements accounted for as successful sale-leaseback transactions

If the construction period ended before the beginning of the earliest period presented, and the transaction qualified for sale-leaseback accounting under current US GAAP before that date, the lessee only accounts for a lease, because the build-to-suit assets and liabilities would already have been derecognized. The lessee applies the transition requirements in the same manner as it does for other sale-leaseback transactions in transition. Section 13.7 of our April 2016 Issues In-Depth discusses the sale-leaseback transition provisions of Topic 842.

KPMG observation:
Transition

Control guidance applies only on or after the effective date

The changes to the sale-leaseback guidance in Topic 842 will make it easier for a lessee that is the accounting owner of an asset under construction to derecognize the underlying asset at the end of the construction period.

We believe that the FASB did not intend for a lessee to look back to periods before the effective date of Topic 842 to determine whether it would have been the accounting owner of an asset under construction. This intention would be inconsistent with much of the Board's rationale for its transition approach. It also would appear to be at odds with the guidance on sale-leaseback transactions that says the lessee does not reconsider whether a successful sale that occurred before the effective date also would have also been successful under Topic 842.

Instead, Topic 842 requires that the lessee consider whether it is the owner of an asset under construction only if construction is ongoing at the effective date.

Topic 842 does not appear to *prohibit* reevaluation of ownership if the lessee was not the accounting owner under current US GAAP

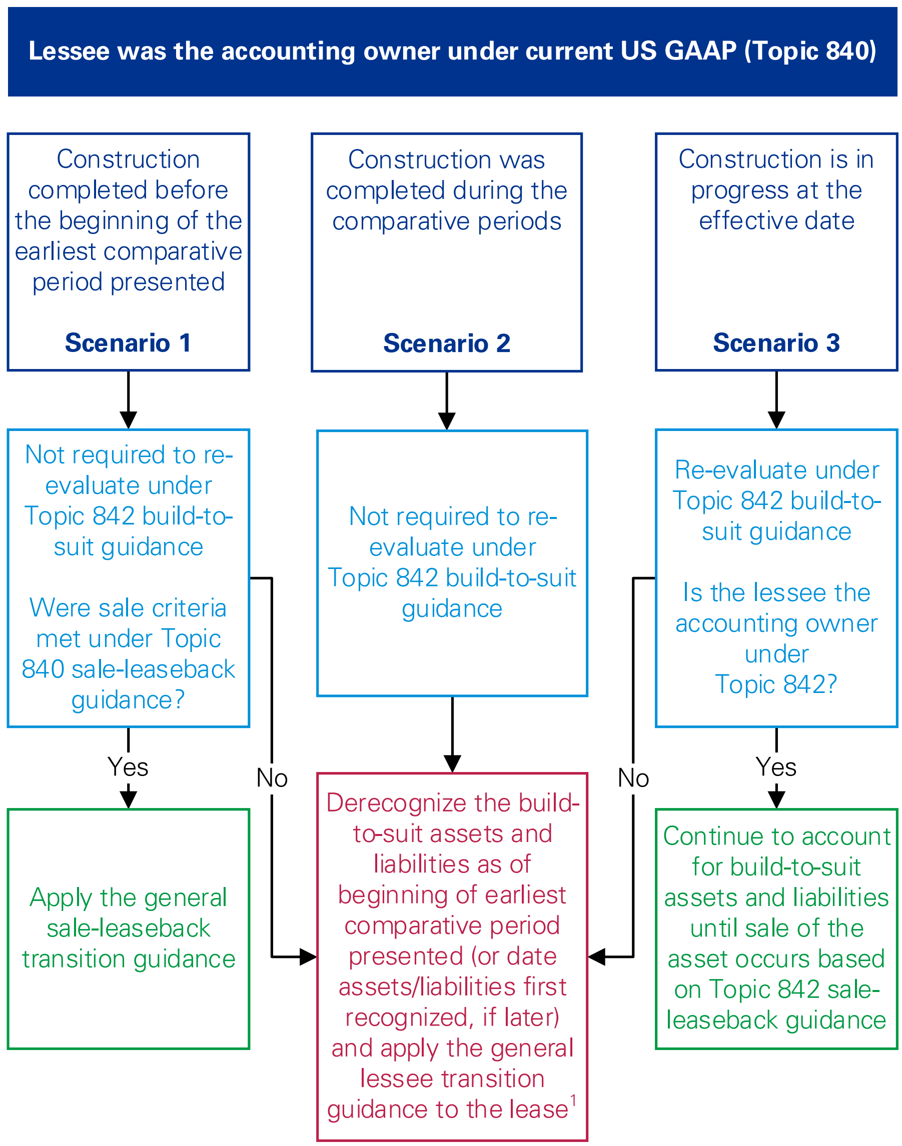
The transition guidance for existing build-to-suit assets and liabilities appears to preclude continued recognition of build-to-suit assets and liabilities on the balance sheet when construction is complete by the effective date, even if the lessee would have been the accounting owner of the underlying asset under Topic 842.

However, because the transition guidance is silent, we believe that it does not prohibit a lessee from evaluating under Topic 842 whether it was the accounting owner of an asset for which construction was complete by the effective date and for which it was **not** the accounting owner under current US GAAP.

We expect it to be rare that a lessee would choose to voluntarily make this evaluation. However, if it does, we believe that it would recognize the assets and liabilities arising from being the accounting owner of an asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it becomes the accounting owner of the asset under construction. The lessee would account for the transaction from the recognition date using the Topic 842 sale-leaseback guidance.

Illustrative decision tree

The following information summarizes our understanding of the transition requirements for a number of potential build-to-suit transition scenarios.



Note 1:

Section 13.3 of our April 2016 Issues In-Depth discusses the lessee transition provisions of Topic 842.

Scenario 1:
Construction completed before the beginning of the earliest comparative period presented

Do not reevaluate whether lessee would have been accounting owner under Topic 842

The lessee should not evaluate whether it would have been the accounting owner of the asset under Topic 842, because construction was completed before the effective date. The lessee's transition accounting will depend on whether the current US GAAP sale criteria for a sale-leaseback transaction were met.

Were the current US GAAP sale criteria for a sale-leaseback transaction met?

When the current US GAAP sale criteria for a sale-leaseback transaction were met before the beginning of the earliest comparative period presented, the lessee does not reevaluate that conclusion, and applies the Topic 842 transition guidance to the sale-leaseback.

Failed sale-leaseback transaction under current US GAAP

When the construction period ended before the beginning of the earliest comparative period presented, but the current US GAAP sale criteria for a sale-leaseback transaction were not met, the lessee derecognizes the build-to-suit assets and liabilities that were recognized under current US GAAP as of the beginning of the earliest comparative period presented. Any difference is recorded as an adjustment to equity at that date. The lessee then applies the transition guidance to the lease.

Scenario 2:
Construction was completed during the comparative periods

Do not evaluate whether lessee would have been accounting owner under Topic 842

The lessee should not evaluate whether it would have been the accounting owner of the asset under construction based on the new leases guidance because the construction was completed before the effective date.

Therefore, the lessee derecognizes the build-to-suit assets and liabilities that it recognized under current US GAAP as of the later of (a) the beginning of the earliest comparative period presented, and (b) the date the lessee was determined to be the accounting owner of the underlying asset. Any difference is recorded as an adjustment to equity at that date. The lessee then applies the general lessee transition guidance to the lease.

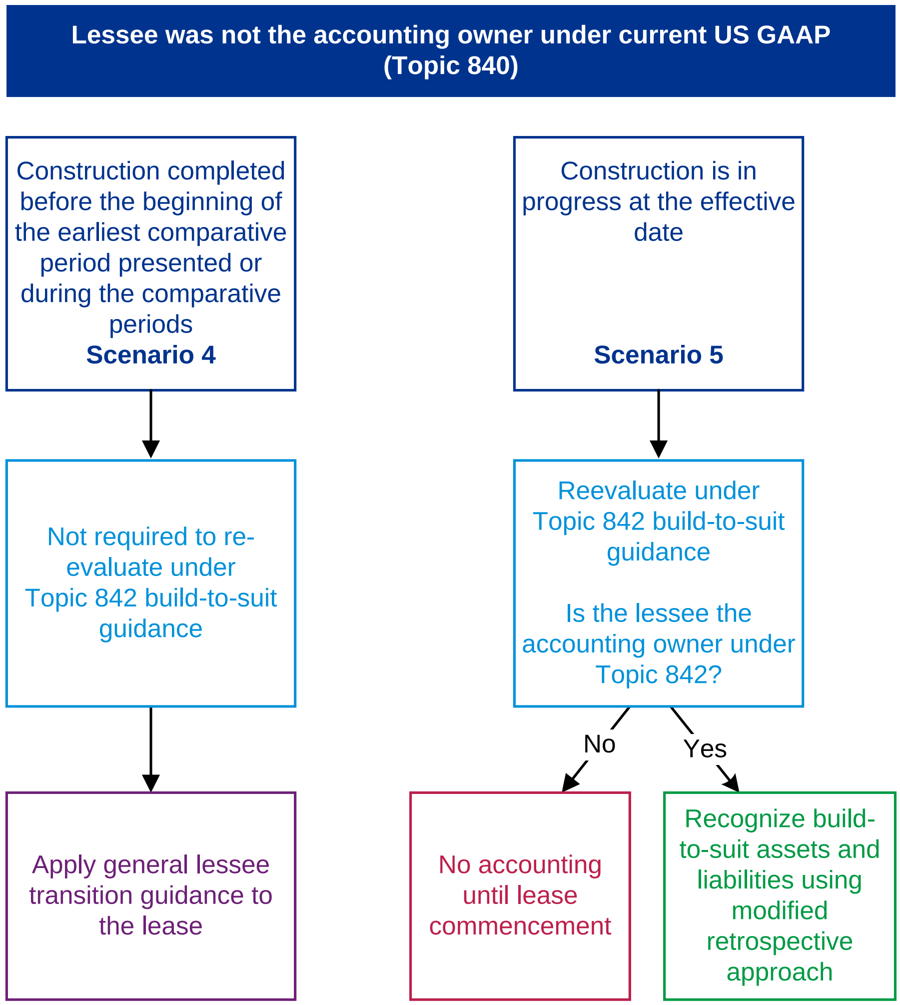
Scenario 3: **Construction is in progress at the effective date**

When lessee is the accounting owner under Topic 842

The lessee continues to recognize the construction-in-progress assets and liabilities that arose because the lessee is the accounting owner until they qualify for derecognition under the sale-leaseback requirements of Topic 842. Then the lessee accounts for the transaction in the same manner as other sale-leaseback transactions.

When lessee is not the accounting owner under Topic 842

The lessee derecognizes the build-to-suit assets and liabilities that it recognized under current US GAAP as of the later of (a) the beginning of the earliest comparative period presented, or (b) the date the lessee was determined to be the accounting owner of the asset under current US GAAP. The lessee records the difference as an adjustment to equity at that date. The lessee then applies the general lessee transition guidance to the lease.



Scenario 4: **Construction completed before the beginning of the earliest comparative period presented** or **during the comparative periods**

No requirement to evaluate whether lessee would have been the accounting owner under Topic 842

The lessee is not required to evaluate whether it would have been the accounting owner of the asset while it was under construction in accordance with Topic 842. However, we do not believe the transition guidance prohibits a lessee from making this evaluation.

If the lessee does not undertake this evaluation, it applies the general lessee transition requirements to the lease.

In the unlikely event that the lessee chooses to evaluate whether it would have been the accounting owner under Topic 842, we believe that it would recognize the assets and liabilities arising from being the accounting owner of the asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date it was determined to be the accounting owner of the asset under construction under Topic 842. The lessee would account for the transaction in accordance with the sale-leaseback guidance in Topic 842 from the date of recognition.

Scenario 5: **Construction is in progress at the effective date**

Lessee is required to evaluate whether it is the accounting owner under Topic 842

The lessee must evaluate whether it controls, at the effective date of Topic 842, an underlying asset a developer is presently constructing or designing that it will subsequently lease. If it controls the underlying asset, it would be the accounting owner under Topic 842.

When lessee is the accounting owner under Topic 842

The lessee should recognize the assets and liabilities resulting from the conclusion that it is the accounting owner of the asset under construction at the later of (1) the beginning of the earliest period presented, or (2) the date the lessee was determined to be the accounting owner of the asset under construction under Topic 842. The lessee will account for the transaction in accordance with the sale-leaseback guidance in Topic 842 from the effective date.

When lessee is not the accounting owner under Topic 842

That means the lessee was neither the accounting owner of the asset under current US GAAP nor under Topic 842. Therefore, the lessee applies the requirements of the new leases standard at lease commencement.

Effective dates and transition

Effective dates		
	First date of adoption for calendar year-end entities	**Effective date**
Public business entities	January 1, 2019	Annual and interim periods in fiscal years beginning after December 15, 2018
Other entities – annual periods	January 1, 2020	Annual periods beginning after December 15, 2019
Other entities – interim periods	January 1, 2021	Interim periods in fiscal years beginning after December 15, 2020
Early adoption	All entities can adopt Topic 842 immediately.	
Transition method	Modified retrospective, which requires application of the new guidance for all periods presented.	

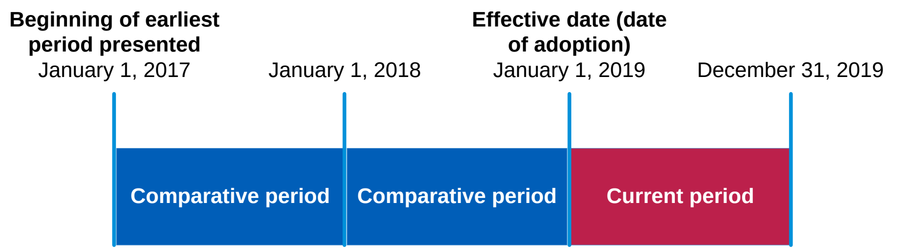
KPMG observation: **Lessees with build-to-suit leases may early adopt**

In many cases, the transition provisions in Topic 842 permit (or require) lessees to derecognize build-to-suit assets and liabilities that were previously recognized under current US GAAP, including such assets and liabilities that have remained recognized because of the existing sale-leaseback requirements.

In addition, the changes to the sale-leaseback guidance in Topic 842 make it easier for many lessees to derecognize build-to-suit assets and liabilities at the end of the construction period. Fewer build-to-suit arrangements for which a lessee is determined to be the accounting owner will result in 'failed sales'.

Therefore, some lessees for which these factors are relevant have indicated they intend to early adopt Topic 842. A calendar year-end public business entity that early adopts will need to quickly begin collecting the information necessary to apply the standard because it is already in the comparative period.

Transition dates for calendar year-end public business entities



KPMG observation: SAB Topic 11.M disclosure of impact on future periods

SEC Staff Accounting Bulletin Topic 11.M (SAB Topic 11.M or SAB 74) requires SEC registrants to evaluate new accounting standards that they have not yet adopted and to disclose their potential material effects. These disclosures generally should include a discussion about the effect that adoption is expected to have on the financial statements, unless this is not known or reasonably estimable.

As discussed in this publication, in transition, a lessee may derecognize significant fixed assets and debt obligations that originally arose from build-to-suit lease arrangements. In their place, the lessee may recognize ROU assets and lease liabilities for the lease of the constructed assets. If this is the case for a lessee, amongst other disclosures it should likely provide in accordance with SAB Topic 11.M, it should disclose these facts and provide a quantification of the related amounts. If precise quantification of the amounts is not yet practicable, a range may be provided. We believe the SEC generally expects that a lessee will refine its estimates (i.e. narrow ranges previously provided) as the effective date approaches and that it will not be acceptable for an entity to provide 'boilerplate' disclosures while only stating that it is continuing to evaluate the impact of Topic 842.

Read KPMG's Executive View on SAB 74 and the leases transition disclosures.

KPMG's Financial Reporting View

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