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Is the Hospitality Industry Ready for the New Lease Accounting Standards?

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ABSTRACT

The days where companies can use off-balance sheet leases are coming to an end. The new lease accounting standards, ASU 842 and IFRS 16, released in early 2016, will be effective, respectively, on December 15, 2018, and January 1, 2019. Under the new standards, virtually all leases will be recognized on a lessee's balance sheet. Hence, financial statements and ratios of companies that heavily use off-balance sheet leases will be considerably impacted. Our analysis of the off-balance sheet leases by the hospitality industry indicates that hospitality companies do extensively use these operating leases, which amounted to 51% of their assets in 2015. The expected widespread unfavorable impact on a lessee's debt ratios and interest coverages could also affect a hospitality company's borrowing rates and debt covenants. Given that the implementation is most likely time consuming, not just costly, the earlier the hospitality companies are prepared for the new standards the better.

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Leasing is commonly used by companies worldwide to gain access to physical assets, to acquire financing, and to reduce an entity's risk exposure to asset obsolescence and residual value uncertainty. Companies in the hospitality and other industries, such as retailers, airlines, and package delivery, extensively utilize leasing. Our analysis shows that in 2015 total undiscounted, operating-lease payments amounted to roughly $66 billion for North American, publicly traded, hospitality companies. These amounts averaged approximately 51% of their total assets and 45% of their sales revenue. The International Accounting Standards Board (IASB) recently reported that a sample of 69 global companies in the travel and leisure industry (which includes the tourism and hospitality industries) had $115 billion (undiscounted value) of off-balance sheet leases, which equaled 29% of their total assets (IASB, 2016). Furthermore, extant empirical evidence suggests that hotel firms have been increasingly leasing instead of buying assets and substituting leases for debt (on average, every dollar of leases displaced 50 cents of debt) during the past two decades (Koh & Jang, 2009).

Lease accounting standards are established by the IASB and the U.S. Financial Accounting Standards Board (FASB). Most countries, except the United States, mandate that public business entities use the International Financial Reporting Standards (IFRS) issued by the IASB. Naturally, companies in the United States follow the Generally Accepted Accounting Principles (GAAP) published by the FASB. The current dual-lease (capital and operating) accounting model, supported by both FASB and IASB, has long been criticized because it does not always deliver a faithful and transparent representation of lease transactions and obligations. The issue in a nutshell is as follows. Many leases are structured, intentionally or unintentionally, so as to be considered an operating lease, although both operating and capital leases are legally binding contracts. For instance, under GAAP, when the present value of the future lease payments equals 90% or more of an asset's value, the lease must be treated as a capital lease. However, if the present value is just slightly smaller, say 89%, the lessee can treat it as an operating lease. Unlike a capital lease, the assets and liabilities created by an operating lease are not recognized on a lessee's balance sheet besides in

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financial statement footnotes under the current accounting model. The lack of information about these off-balance sheet leases makes it difficult for stakeholders to properly compare companies that lease instead of borrowing to buy assets. A case in point, albeit outside the hospitality industry, was Circuit City, a retail electronics store that filed for bankruptcy in 2008. Circuit City reported only about $50 million in debt on its balance sheet. Yet, it had over $4.5 billion in undiscounted operating-lease commitments not shown on its balance sheet other than in footnotes (IASB, 2014).

The U.S. Securities and Exchange Commission (SEC) in 2005 estimated that SEC registrants had approximately $1.25 trillion in off-balance leases, and recommended changes be made to the current lease accounting model. There is no sign that the usage of off-balance sheet leases is abating, evidenced by the latest estimate of $2 trillion in leases used by U.S. public companies (Rapoport, 2015). The IASB and the FASB initiated a joint project in 2006, aiming to improve the current lease accounting standard. After issuing three documents for public comment, engaging in extensive outreach activities, and addressing stakeholders' concerns, the FASB and the IASB in early 2016 finally each issued their own new standard—Accounting Standards Update (ASU) 842 and IFRS 16. For public companies, ASU 842 is effective for accounting periods beginning after December 15, 2018. IFRS 16 is instead effective for accounting periods beginning on or after January 1, 2019. Although this joint project resulted in two separate lease accounting models, the IASB and FASB have reached similar conclusions on many issues, and chief among them is that both boards will mandate virtually all leases be reported on a lessee's balance sheet. One of the main differences is that whereas the IASB requires all leases to be accounted for as finance leases, the FASB maintains the dual-lease distinction on the income statement and the statement of cash flows.

Since lessees are required to recognize lease assets and lease obligations on their balance sheets by both ASU 842 (FASB, 2016) and IFRS 16, one impact is that lessees will appear to have more assets and be more heavily leveraged than before. Unlike ASU 842, which requires lessees to treat an operating-lease payment as operating costs, IFRS 16 requires lease expenses to be reported separately as depreciation and interest expenses. Consequently, leases identified as operating leases under ASU 842 must be accounted for differently by lessees under IFRS 16, resulting in different impacts on the income statement and cash flows statement. Nevertheless, these two new lease accounting models will impinge on a lessee's balance sheet, income statement, and financial ratios, such as leverage ratios and performance ratios. As a result, a lessee's borrowing cost and debt covenants may also be affected. Lease accounting standards for lessors remain, however, largely unchanged under both new standards.

Consequently, it is paramount and also prudent for companies in the hospitality industry that use heavy off-balance sheet operating leases to understand the new lease accounting models and recognize the new models' impacts on their financial statements and ratios. These companies, especially U.S.-based multinational firms that may have to use both new lease accounting models, must within the next couple of years set up a sound implementation system.

The remainder of this article is organized as follows. After briefly summarizing the major impact of the two new lease accounting standards on a lessee's financial statements, including their similarities and differences, we will demonstrate how each model will affect a lessee's various financial ratios. That is followed by an analysis of the expected impact of new lease accounting models on hospitality firms. With data from Compustat, we will estimate the effect of the new lease accounting standards on the financial statements and relevant financial ratios of hospitality firms. The key implementation steps for both models will then be explored. Given the sweeping impacts of the new lease accounting standards, we therefore review the implications for both hospitality companies and educators in hospitality finance and accounting. Limitations of this study and areas for future research are then discussed. The last section concludes this study.

Lease accounting standards

Current lease accounting standards

Lease accounting is governed by the U.S. GAAP (FASB Topic 840) and the IASB (International Accounting Standard or IAS 17). The single

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largest concern regarding both current lease accounting standards is the lack of transparency of information on lease obligations. Both standards allow a lessee to classify a lease as an operating lease if it transfers only the use of the asset. The lease expense is treated as an operating expense in the income statement, while the lease itself is not reported on the balance sheet (hence, off-balance sheet lease). On the contrary, when the lease is economically similar to buying the asset, the lease is classified as a capital (under GAAP) or finance (under IFRS) lease. Accounting for a capital/finance lease is entirely different from an operating lease, because a capital/finance lease is recognized both as an asset and a liability (the present value of the lease payments) and the lessee must each year claim depreciation on the asset and deduct the interest expense component of the lease.

Obviously, how to classify a lease decides whether a lease must be reported on the balance sheet, and there is a difference between the FASB's and the IASB's lease classifications. In essence, the U.S. GAAP's classification depends on whether the lease meets certain criteria, while the IFRS's relies on the substance of the lease. Two commonly mentioned GAAP criteria that qualify a lease as a capital lease are whether the lease term equals or exceeds 75% of the estimated useful life of the leased asset and whether the present value of the lease payments equals or exceeds 90% of the total original cost of the asset. When a lease does not meet any of these two or other criteria, such as the ownership of the asset is transferred to the lessee by the end of the lease term, the lease contract is an operating lease. Alternatively, rather than relying on specific criteria, the IFRS focuses on whether the lease is in substance a finance lease. The IFRS provides a list of examples and indicators that a lessee can use to classify a lease, although these examples and indicators are not always conclusive. For instance, if the lease is for the *majority* of the economic life of the asset or if the present value of the lease payments represents a *substantial* amount of the fair value of the asset, it is a finance lease. Otherwise, it is an operating lease. Of course, interpretations of the terms *majority* and *substantial* may vary.

New lease accounting standards

As mentioned earlier, although the FASB and the IASB embarked on this as a joint project in 2006 to improve the current standards, they concluded by each issuing their own new standard—ASU 842 and IFRS 16. Table 1 summarizes the similarities and differences between the two new standards.

It is apparent from Table 1 that operating leases, not finance leases, are now treated differently under both new standards. Table 2 highlights how each standard deals with the operating (off-balance sheet) lease.

It is clear that for firms with what are now considered operating leases, both balance-sheet assets and balance-sheet liabilities under both new lease accounting models will increase, because all leases must be recognized on a lessee's balance sheet. However, since the FASB model preserves the dual-lease distinction on a lessee's income statement, only the IASB model will affect a lessee's income statement, because the expenses of formerly off-balance sheet leases must be separated into depreciation and interest expenses. The new

Table 1. Lease Recognition and Accounting Model.

	FASB Model (ASU 842)	IASB Model (IFRS 16)
Lease Definition	A contract that conveys the right of use of an identified asset for a period of time to the lessee who has the right to direct the use of the asset and obtains substantially all the economic benefits from the asset.	
Lease Classification	Dual lease: • Finance (instead of capital) lease and operating lease • Similar to the current GAAP criteria	Single lease: • No more dual-lease distinction • All leases are finance leases
Accounting Model	• Both finance and operating leases recognized on balance sheet • Finance leases treated as a financed asset purchase • Operating leases generally have straight-line recognition of total lease expenses	All leases recognized on balance sheet and are treated as a financed asset purchase
Short-Term Leases	Optional lease recognition for leases of 12 months or less.	
Low-Value Assets	No exemption	Optional lease recognition for leases of low-value assets ($5,000 or less) such as personal computers and office furniture

Table 2. Treatments of Operating Leases by New Lease Accounting Standards.

	Current FASB Standard		ASU 842
	Operating Leases	Finance Leases	All Leases
Balance Sheet			
Assets	—	$$	$$$$$$
Liabilities	—	$$	$$$$$$
Off-Balance Sheet Rights and Obligations	$$$$	—	None allowed
Income Statement			
Operating Expense	Single expense	—	Same as current
Depreciation	—	$	Same as current
Interest	—	$	Same as current

	Current IASB Standard		IFRS 16
	Operating Leases	Finance Leases	All Leases
Balance Sheet			
Assets	—	$$	$$$$$$
Liabilities	—	$$	$$$$$$
Off-Balance Sheet Rights and Obligations	$$$$	—	None allowed
Income Statement			
Operating Expense	Single expense	—	—
Depreciation	—	$	$$$
Interest	—	$	$$$

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treatments of operating leases unequivocally affect a lessee's financial statements, and hence financial ratios and impacts will be discussed in the following section.

The new standards' impact on financial statements and ratios

The effect on a lessee's balance sheet by the treatment of an operating lease is presented in Table 3.

"Separate presentation" in Table 3 means that the lease liabilities are listed as separate lease liabilities distinguished from other liabilities. And leased assets are similarly explicitly identified as leased assets on the balance sheet under ASU 842, but not IFRS 16.

Next, Table 4 details the impact of the new standards on a firm's income statement and cash flow statement.

Unlike the FASB, the IASB regards all leases as finance leases; therefore, the single expense (under

Table 3. New Lease Accounting Standards' Impact on the Balance Sheet.

	ASU 842	IFRS 16
Recognition	✓	✓
Measurement		
Liabilities	Lease liability = present value of unpaid lease payments[a]	
Assets	Initial lease asset = lease liability + initial direct cost + prepaid lease payments	
Presentation		
Liabilities	Separate presentation	Separate presentation
Assets	Separate presentation	As if owned or own line item

[a]The discount rate is the implicate rate of the lease if determinable; otherwise, it is the lessee's marginal borrowing rate.

Table 4. New Lease Accounting Standards' Impact on the Income Statement and Cash Flow Statement.

Income Statement	ASU 842	IFRS 16
Revenue	No Impact (⟺)	No Impact (⟺)
Operating Cost (Excluding Depreciation and Amortization)	Single expense lease payment (same as before)	No expense (previously included lease payments)
EBITDA	⟺	⇧
Depreciation and Amortization	⟺	+ Depreciation
Operating Profit	⟺	⇧
Finance Cost	⟺	+ Interest Expense
Before-Tax Profit	⟺	⟺
Cash Flow Statement		
Operating Activities	Lease Payment (same as before)	Interest[a] (instead of lease payment)
Financing Activities	—	+ Principal

[a]The IASB allows interest payments to be presented within operating activities or financing activities.

IAS 17) of a former operating lease will now be separated into implicit interest expense (finance cost) and depreciation expense, resulting in a higher earnings before interest, tax, depreciation and amortization (EBITDA), and operating profit. However, the before-tax profit will remain the same. This different treatment also leads to different impacts on the cash flow statement, although the two lease accounting models do not give rise to differences in a lessee's total cash flows. Applying IFRS 16 instead of ASU 842, a lessee is expected to report less operating cash outflows, but with a corresponding increase in financing cash outflows.

As a lessee's balance sheet and income statement are impinged by the new treatment of the formerly off-balance sheet leases, its financial ratios will also be affected. Table 5 underscores how major ratios will be impacted.

The most salient impact by the two lease accounting models on lessee accounting is that lessees are expected to be more financially leveraged, because lease liabilities that were previously unrecognized are now recognized on their balance sheets. By the same token, as lease assets are also recognized, thus increasing total assets, asset-related profitability ratios are expected to decline and total asset turnover is expected to decline as well. Additionally, a lessee's liquidity is expected to appear more depressed with a lower current ratio.

Expected impact on the hospitality industry

The IASB estimates that roughly 14,000 corporations listed throughout the world using IFRS or GAAP disclosed about US$2.86 trillion (undiscounted value) of off-balance sheet lease obligations (IASB, 2016). With a sample of 1,022 companies from the 14,000 corporations, the IASB also reports that 69 companies in the travel and leisure industry had an amount of $115 billion undiscounted, or $83 billion present value, of off-balance sheet leases, which equaled 29% and 21%, respectively, of their total assets. A more ominous concern to the travel and leisure industry is that the IASB also projects that under IFRS 16, companies in the industry would report a long-term debt-to-equity ratio of 191% instead of 118% under the current model. That is a whopping 62% increase in the long-term debt to equity ratio.

A similar sentiment is shared by other professional organizations. Recently, PricewaterhouseCoopers, in a global lease study of 3,000 non-U.S. listed companies across a wide range of industries, concluded that the median increase in debt for these companies is 22% (PWC, 2016). Two industries (airlines and transport and logistics) that are related to hospitality will have 42% and 24% more debt, respectively, according to the same study. After surveying 138 executives (lessees or lessors) from various industries, Deloitte Development reports that 80% and 75%, respectively, of equipment and real estate lessees expected material, unfavorable impacts from the new lease accounting

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Table 5. New Lease Accounting Standards' Expected Effects on Key Financial Ratios.

Financial Ratio	ASU 842	IFRS 16	Reason
Long-Term Solvency Debt Ratio = Total Liabilities/Total Assets	⇧	⇧	Liabilities increase proportionately more than assets for most companies.
Interest Coverage = EBITDA/Interest Expense	⇔	Depends	ASU does not expect to affect EBITDA or interest expense but IFRS will increase both.
Liabilities/EBITDA	⇧	Depends	ASU increases liabilities and no impact on EBITDA but IFRS 16 will increase both.
Liquidity			
Current Ratio = Current Assets/Current Liabilities	⇩	⇩	Current lease liabilities but not current assets will increase under both models.
Asset Management			
Asset Turnover = Sales/Total Assets	⇩	⇩	Lease assets are now recognized as part of total assets under both models.
Profitability			
Operating Profit Margin = EBIT/Sales	⇔	⇧	EBIT would increase under IFRS, because the depreciation charge added is smaller than the single expense lease payment previously used.
Return on Assets = Net Income/Average Assets	⇩	⇩	Lease assets are now recognized as part of total assets under both models, while the net income is not expected to change.

models on their debt-to-equity ratio and return-to-assets ratio (Deloitte Development, 2014).

Kostolansky, Altschuler, and Stanko (2012) investigate the impact of the new lease accounting models and document that 47 eating and drinking places will see their average total assets increase by 50%, average total liabilities by 96%, average debt-to-assets ratio by 29%, and average return-on-assets ratio decrease by 29%.

To gain more insight into the impact of the new lease accounting models on the hospitality industry in the United States, we collected operating lease–related data for all retail and service industry companies from Compustat for 2015. We then used four Standard Industrial Classification (SIC) codes (5810, 5812 for restaurants; 7011 for lodging; and 7990 for casinos) to extract data for hospitality companies. Eating and drinking places (5810 and 5182) are considered part of the retail industry. Lodging and casinos are considered part of the service industry. Table 6 sums up our findings.

The eating and drinking places industry is dominant in every measure of operating-lease usage, except for the percentage increase in average total debt. However this is the one measure that will be influenced by large companies. The casino sector in the hospitality industry had higher operating-lease usage than the service industry, according to several of the measures. The average percentage increase in total assets in Table 6 is probably the best measure of the extent of lease use in an industry. We have approximated the value of leased (operating) assets for each company by computing the present value of all operating-lease payments, assuming a discount rate of 5%. We then increased the value of each company's total assets by this value and then computed the percentage of leased (operating) assets to total assets. The results are still very similar to the other measures. Eating and drinking places are relatively heavy users of operating leases, and casinos are slightly heavier users relative to the service industry as a whole. Recent empirical evidence suggests many hotel companies have increasingly used leases instead of borrowing to buy assets over the last two decades (Koh & Jang, 2009).

Our data show that the hotels and motels industry is a relatively light user of operating leases. In summary, our analysis confirms that some sectors of the hospitality industry are relatively heavy users of operating leases, and underscores the nontrivial, negative effect the new lease accounting models may have on the debt ratios, assets-based profitability ratios, total asset turnover ratio, and potentially interest coverage ratios of companies in the hospital industry, especially eating and drinking places.

We present the expected impact on financial ratios of the 143 hospitality firms in Table 7. These firms are first broken into the same three categories: eating and drinking places, hotels and motels, and casinos. With

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Table 6. Analysis of Operating Lease Payments by Hospitality Industry With 2015 Compustat Data.

Industry and SIC Codes	Number of Companies	Total Lease Payments ($ Billions)	Average of Total Lease Payments to Total Assets	Average of Total Lease Payments to Sales	Average Percentage Increase in Total Assets[a] (Based on PV)	Percentage Increase in Total Debt[b] (Based on PV)
Eating and Drinking Places (5810 and 5812)	78	$ 53	69%	58%	53.69%	49.84%
Hotels and Motels (7011)	24	$ 7	6%	13%	3.66%	11.41%
Casinos (7990)	41	$ 7	44%	39%	16.88%	4.01%
Retail (5200 to 5999)	305	$386	47%	31%	39.99%	65.60%
Service (7000 to 8744)	976	$169	15%	48%	13.10%	16.36%

[a]This is the average of each company's percent increase in total assets due to including operating lease assets in the balance sheet. As a result, large companies have the same influence as small companies, giving a better overall picture of the typical influence of accounting changes on a company's total assets.

[b]This shows the influence of including operating lease liabilities on the balance sheet. Some companies had no debt, and thus the percent increase due to including this lease debt is undefined. Thus, we cannot compute an average percent increase in total debt, and instead measured the percent increase in average total debt. However this will be more heavily influenced by large companies than small companies.

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Table 7. Expected Effects on Key Financial Ratios for Those Firms With Leases Formerly Classified as Operating Leases.

	2015 Actual Average	2015 Expected Average*
Total Debt/Total Assets (Debt Ratio)		
Eating and Drinking Places (5810 and 5812)	35.49%	55.75%
Hotels and Motels (7011)	63.69%	65.39%
Casinos (7990)	38.60%	44.37%
Long-Term Debt/Total Assets		
Eating and Drinking Places (5810 and 5812)	32.54%	49.48%
Hotels and Motels (7011)	48.12%	49.71%
Casinos (7990)	36.35%	41.70%
Curr Assets/Curr Liabilities (Current Ratio)		
Eating and Drinking Places (5810 and 5812)	1.92	1.03
Hotels and Motels (7011)	0.98	0.92
Casinos (7990)	1.57	1.40
Sales Revenue/Total Assets (Total Asset Turn)		
Eating and Drinking Places (5810 and 5812)	1.25	0.82
Hotels and Motels (7011)	0.56	0.54
Casinos (7990)	0.86	0.73
Net Income/Total Assets (ROA or ROI)		
Eating and Drinking Places (5810 and 5812)	7.89%	5.41%
Hotels and Motels (7011)	5.80%	5.44%
Casinos (7990)	17.28%	16.06%

[a]Expected average estimates of what the financial ratios would likely be in 2015 under the new rule.

financial data from 2015, we compute the actual ratios for each firm, and then show the unweighted average for each ratio. We then approximate the present value of all operating-lease payments using a 5% discount rate and the disclosures of operating-lease payments for year 1, year 2, year 3, year 4, year 5, and the total for more than 5 years. We discount the operating-lease payments back 0.5 year, 1.5 years, 2.5 years, 3.5 years, 4.5 year, and 6 years, respectively, and sum the six present values. This is used to increase the values for each firm's total liabilities as well as their total assets. The new data are then used to estimate what the same financial ratios would be under the new rules if applied in 2015.

All the expected new ratios in the table changed as predicated. For example, the debt-ratio average for eating and drinking places increases from 35.49% to 55.75%. But what is really surprising is the drastic change in firms' current ratio. The current ratio is expected to decline because the current portion of lease payments would be included in current liabilities. The average current ratio for eating and drinking places declines from 1.92 to 1.03! The results

of this table illustrate another problem companies are going to have after enactment of the new rules—explaining the deterioration of financial ratios to investors.

Effects on borrowing costs and debt covenants

Since lessees with significant off-balance sheet leases are expected to report more financial liabilities on their balance sheets, it is simply natural to question whether a lessee's borrowing costs and debt covenants would be affected. One of the determinants of borrowing costs is the borrower's credit risk, which is assessed by its credit rating. After analyzing 5,812 bank loans, Altamuro, Johnston, Pandit, and Zhang (2014) conclude that the capitalization of operating leases has no material impact on a company's S&P credit rating, probably because credit market participants have already incorporated operating-lease information in the credit risk assessment. This proposition is supported at least by Fitch Ratings, which states that the new lease accounting models would not affect its corporate debt rating because it has always and will continue to rely on its own method to incorporate operating-lease information in its assessment (Shumsky, 2016a). As a result, the borrowing costs for lessees who have available credit ratings are not expected to be affected by the lease accounting models. On the contrary, Altamuro et al. (2014) also reports that for companies that do not have credit ratings available, their borrowing costs seem to be affected by their financial ratios.

Consequently, the exact impact on the borrowing cost of a hospitality company probably depends on whether it is rated by a credit rating agency, and how likely the agency will change its credit rating. For companies such as eating places that extensively use operating leases, their borrowing costs probably will also depend on how different their recognized lease liabilities are from previously estimated.

The IASB and the FASB realize the possible effect the new lease accounting models might have on lessees' debt covenants. But both boards also point out that most loan agreements contain "frozen GAAP" or "semifrozen GAAP" provisions that would protect a borrower from changes in accounting. The frozen GAAP provision essentially means a firm's financial ratios will be evaluated using the accounting standards in existence at the time the loan was initially granted. This is extensively corroborated by Moody's study of corporate credit agreements in 2011, which shows that nearly all the sample agreements had such clauses (Moody's, 2011).

Nevertheless, this view appears to have mixed support from other professionals. For instance, on September 2, 2014, the *Wall Street Journal* reported that a survey conducted by Grant Thornton International Ltd., an accounting firm, indicated that about 50% of global (75% of North American) companies believe their commercial loans have debt covenants that could require them to repay a loan if they violate any covenants (Chasan, 2014). At the time, however, only 8% and 5%, respectively, of these companies thought the new lease accounting models would affect their debt covenants. Similarly, the Deloitte's 2013 survey indicated that 45% of executives believed it would be more difficult under the new lease standards for them to secure debt financing (Deloitte Development, 2014). And about two-thirds of the executives also thought their debt covenants would be affected, although 40% believed their bankers would adjust their debt covenants.

Putting it all together, companies in the hospitality industry should probably evaluate their lease agreements thoroughly to ensure they contain either the frozen GAAP or semifrozen GAAP clause. And it is equally important for them to communicate with their bankers or bond trustees about how their debt covenants might be impacted. Furthermore, Lee, Huh, and Lee (2015) provide evidence indicating that hotel companies rely on operating leases instead of debt financing, especially in economic downturns. Hence, it is even more imperative in contracting business cycles for hospitality companies to recognize how their borrowing costs and debt covenants would be affected.

Implementation

Both IASB and FASB recognize that companies (such as an eating place) with material off-balance sheet leases will incur costs when implementing the new lease accounting models. The Securities and Exchange Commission in 2008 estimated that

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"the largest U.S. registrants that adopt IFRS early would incur about $32 million per company in additional costs for their first IFRS-prepared annual reports, and that the average U.S. company would incur costs of between 0.125% to 0.13% of revenue" (American Institute of Certified Public Accountants, 2008). The costs are probably more burdensome for U.S.-based multinational hospitality companies with a substantial overseas presence (such as a subsidiary that is publicly listed in the European Union), because these companies reporting consolidated financial statements in the United States (hence, using ASU 842) also have to report in IFRS (thus, using IFRS 16) for their foreign subsidiaries. Of course, the significance of the costs depends on the size of the lease portfolio and the existing system for leases.

The key implementation step involves setting up a system and procedure (more likely an IT system and procedure) that will identify a lease and then extract, gather, and validate data for each lease. The system and procedure should allow a lessee to easily determine the discount rate for each lease, which will be used to estimate the lease liability (the present value of the unpaid lease payments). In addition, a lessee should be able to recognize with the system and procedure the impacts of the lease portfolio on its financial statements and ratios. With the system and procedure in place, educating and training staff will be costly, and will require time and resources. Companies will incur additional costs at the beginning of the implementation period when communicating how their financial statements and ratios are impacted to external stakeholders, such as analysts and investors.

So, is the hospitality industry ready for the new lease accounting models? Most likely, not yet, if how companies are presently managing another new FASB rule (revenue recognition standard) is an indication of things to come. Specifically, companies are required to apply the new revenue recognition guidelines to annual report periods beginning after December 15, 2017. Yet, the *Wall Street Journal* reported on December 12, 2016, that only 15 companies out of the S&P 100 have disclosed their plan to make the transition to the new revenue recognition accounting standard (Shumsky, 2016b).

Not surprisingly, Michael Keeler, CEO of LeaseAccelerator, believes "that many Fortune 500 companies are woefully unprepared for the new lease accounting standards, especially their equipment lease portfolio" partly because "of the uncertainty of the timing of the issuance of the new standard, the readiness activity has been a little slower" (Cohn, 2016).

In addition, the survey conducted by Deloitte of 138 executives also gives little indication that companies were ready back in 2013 (Deloitte Development, 2014). For instance, only 1% of the real estate lessees said they were "extremely ready" or "very prepared" to implement the new standards. Also, 50% of them believed it would take at least one year to implement the new standards. Equally alarming, about 80% of the executives felt it would be difficult for their companies to comply with the new standards. Furthermore, these executives listed several major challenges. Chief among them are concerns about the quarterly adjustments/reassessments for the balance sheet due to the leases, the integrity and sufficiency of lease data, and the adequacy of their IT systems.

Implications

Obviously, hospitality companies with material off-balance sheet leases will be the most impacted by the new lease accounting standards. Given the depth and breadth of the implementation and the fast-approaching deadlines, the implications are far reaching because noncompliance with either the U.S. GAAP or the IFRS will unequivocally result in grave consequences. This is especially challenging for companies that are required to disclose financial statements according to both GAAP and IFRS.

Consequently, hospitality companies that do not yet have a sound strategy must move posthaste toward complying with a comprehensive list of implementation steps. They should begin by providing pertinent training to accounting, finance, and operating personnel around the new standards. Companies may have to develop new systems and processes to compile a complete list of their existing lease inventories. This will be particularly

challenging for a hospitality company that is either global or decentralized, because lease-related information is more dispersed. Executives may also need to consider whether any of the existing leases must be reclassified under the new standards and re-evaluate certain lease-versus-buy decisions because all leases must be reported on the balance sheets.

It is imperative for educators teaching or authoring textbooks in hospitality finance and accounting to expose students to the upcoming new standards and how they improve on the current standards. Students must also be aware of the major similarities and differences between the two new standards. Special emphasis, including case studies, should be placed on explaining to students how the new standards will impact a lessee's financial statements and ratios.

Limitations

The limitations to the research and results of this article are primarily based on uncertainty and a lack of information. Our empirical results are based on a calculation of the present value of a firm's operating-lease payments. We believe we have reasonably estimated this; however, it is just an estimate for the following two reasons:

(1) Although we know the approximate discount rate firms use to compute the present value of future lease payments, we do not know the exact rate each firm will use.
(2) Although we know the approximate time in the future when lease payments are due, we do not know the exact timing. For example all lease payments due more than five years in the future are lumped together into one category, and we have discounted all these future lease payments as if they will be due six years in the future. Fortunately, most firms have a small proportion of their lease payments in this category.

Other limitations of our study include uncertainty regarding the possibility of debt covenant violations. We believe this may not be a problem for many, if any, companies, but there is no way to know this without an examination of each firm's debt covenants, and even if it is a possible problem, creditors may very well not enforce a debt covenant violation that is caused by an accounting standard change.

In terms of companies complying with the new standards, if a company has to comply with both new standards (ASU 842 and IFRS 16), this will possibly be doubly costly. However we believe this will be the case for only large companies with a substantial international presence.

We hope the results of this study can be generalized to all hospitality firms. However, we have only considered three sectors of the hospitality industry: eating and drinking establishments, lodging, and casinos. We recognize there are other sectors of the hospitality industry we have not taken into account, and there is probably not universal agreement about exactly what sectors do belong to the hospitality industry.

Future research

A look at the limitations of our study provides opportunities for future research about the impacts of the new lease accounting standards. The most obvious is that once the standards have been in place, we can measure the impacted financial ratios precisely based on the firms' new financial statements, which will be in compliance with the new standards.

Once the new standards have been in place for some time, there should be some evidence of violations of debt covenants and how the violations were handled by the creditors. Also, we should have some information regarding how managements have communicated with stakeholders in order to explain the deterioration in their financial ratios due to the new accounting standards. Both the violations of debt covenants and management explanations for deteriorating financial ratios can probably best be explored through appropriate surveys of management or clinical studies.

Conclusion

We have discussed the similarities and differences between the two new lease accounting standards (ASU 842 and IFRS 16) and their impacts on lessees' financial statements and ratios. Our analysis of 2015 data from Compustat supports that the hospitality industry,

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especially eating and drinking places, extensively utilize operating leases. We also examined how a lessee's financial ratios, borrowing cost, and debt covenants may be affected. Companies' investor relations departments need to be prepared to explain the unfavorable change that will occur in many of their financial ratios. We also believe that concern for borrowing costs is more critical for hospitality companies that do not have a credit rating, because their borrowing costs are more likely to be affected. The implementation is expected to be time consuming and costly. But given the widespread impacts of the two new lease accounting models, it is only prudent and necessary for hospitality companies to be prepared to implement at least one of the new models, if not both, as soon as possible.

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