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Big Changes in Lease Accounting: FASB Releases Final Standards

Authored by Bruce Hickey, Margot Mendelson Hammond and Stephanie Frank

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The Financial Accounting Standards Board (the "FASB") released the long-anticipated final standards, *Leases* (Topic 842) (the "Final Standards" or "Topic 842"), on February 25, 2016, completing an overhaul of the lease accounting standards that was more than ten years in the making in the U.S. The most significant change in lease accounting brought about by the Final Standards is that all leases will now appear on the balance sheet of generally accepted accounting principles ("GAAP") reporting entities. These changes bring an end to the decades-long treatment of accounting for the obligations of lessees under operating leases as operating expenses reflected on income statements rather than as liabilities, with corresponding assets, reflected on balance sheets. As a result, all leases are now viewed as creating an asset and a liability to be recognized on the balance sheets of lessees and lessors.

The FASB commenced the project in 2006 to overhaul lease accounting standards with the twin objectives of providing greater transparency for material lease obligations that are not recognized on balance sheets and converging its lease accounting standards with the lease accounting standards of the International Accounting Standards Board ("IASB") in order to provide consistent reporting of leases across multiple reporting jurisdictions. While the FASB achieved the first goal, it was unsuccessful in achieving the second. In 2014, the two boards agreed to de-link their projects over their disagreement as to whether accounting by lessees should be based on a one-lease model or two-lease model, which distinguishes between capital leases and operating leases. This divergence resulted in the issuance by IASB on January 13, 2016 of International Financial Reporting Standard 16 ("IFRS 16") and the issuance by the FASB of the Final Standards.

This OnPoint will provide historical background on the financial accounting standards for leases, and an overview of the prior treatment of leases and of the future treatment of leases under the Final Standards. This OnPoint will conclude with an assessment of the likely effects of the Final Standards on leasing generally.

Historical Treatment of Leases

Accounting standards in the U.S. have been the domain of the Securities and Exchange Commission (the "SEC") since its inception in 1933. Together with the American Institute of Certified Public Accountants (the "AICPA"), the SEC published Accounting Research Bulletins which set accounting standards for U.S. reporting companies. In 1959, the AICPA created the Accounting Principles Board ("APB") whose objective was to issue official views and opinions on relevant accounting issues. In the area of leasing, the APB issued numerous opinions which set the foundation for modern-day treatment of leases in financial statements.[1]

In 1973, the FASB was created as an independent, private sector, not-for-profit organization to establish financial accounting and reporting standards for GAAP reporting entities. The FASB was also installed as the

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[1] APB Opinion No. 5, "Reporting of Leases in Financial Statements of Lessee" September 1964; APB Opinion No. 7, "Reporting of Leases in Financial Statements of Lessors" May 1966; APB Opinion No. 27, "Accounting for Lease Transactions by Manufacturer or Dealer Lessors" November 1972; and APB Opinion No. 31, "Disclosure of Lease Commitments by Lessees" June 1973.

formal rule-making accounting authority by the SEC.[2] In November of 1976, the FASB issued Statement of Financial Accounting Standards No. 13, Accounting for Leases ("FAS 13"). FAS 13 superseded APB Opinion Nos. 5, 7, 27 and 31 and set forth the governing standard for financial accounting of leases, which lasted nearly forty years until the adoption of the Final Standards. However, as a result of collapses by several high profile corporations in 2001 and 2002, the Sarbanes Oxley Act was enacted in 2002. Section 401 of such Act required that, among other things, financial statements published by issuers must be accurate, not omit to state material information and also include all material off-balance sheet liabilities, obligations and transactions. The SEC was required to study and report on GAAP and disclosure rules as they relate to off-balance sheet transactions. Consequently, the SEC released a report which included an analysis of leases, single purpose entities, consolidations and other topics with potential off balance sheet implications and set forth several recommendations.[3] With respect to leasing, the SEC recommended that accounting guidance for leases be reconsidered to address recognition of lease obligations which approach but do not cross bright lines set forth in lease accounting rules. It was under this climate that the FASB announced in 2006 that it and IASB would initiate a joint project to address the financial accounting of leases.

Lease Accounting Practices Prior to Adoption of the Final Standards

FAS 13 set forth specific rules for determining whether a lease should be accounted for as an "operating lease," which would not appear on the balance sheet, or a "capital lease," which would be treated the same as conventional debt on the balance sheet. Briefly put, the rules were that a lease was a capital lease if: (i) it transferred ownership of the asset to the lessee at the end of the lease term, (ii) it contained a bargain purchase option, (iii) the term of the lease was equal to 75% or more of the estimated economic life of the leased asset, and (iv) the present value at the beginning of the lease term of the minimum lease payments equaled or exceeded 90% of the fair value of the leased asset. Determining the present value of future rent necessitates a determination of a discount rate. FAS 13 indicated that the discount rate should be the lessee's incremental borrowing rate unless it was practicable for the lessee to learn the implicit rate of interest in the lease and the implicit rate was lower than the lessee's incremental borrowing rate. With these rules, a fairly bright line was in place to keep a lease off a lessee's balance sheet.

Various other Financial Accounting Standards, Emerging Issues Task Force ("EITF") issues and interpretations relating to leasing have been adopted by the FASB since the issuance of FAS 13. Given the distinction between operating leases and finance leases under the Final Standards (see below), it is likely that most of these views and positions will remain relevant. Among those which are most relevant are FAS 28 (sale-leaseback accounting), FAS 66 (accounting for sales of real estate), FAS 98 (sale-leasebacks of real estate where there is a continuing involvement by the seller/lessee (*e.g.,* option to purchase the leased property or a guarantee of lessor's return on investment) will not result in sale recognition), EITF 96-21 (treatment of costs incurred by a lessee in a build-to-suit transaction), EITF 97-1 (treatment of environmental indemnities from lessees and non-performance related lease default), EITF 97-10 (guidelines for activities of lessee that would constitute indicia of ownership in a build-to-suit context), EITF 00-13 (treatment of equipment which is integral

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[2] See www.fasb.org. Outside of the U.S., a body called the International Accounting Standards Committee was established in 1973 by the accounting organizations of several western European and North American countries as well as Japan and Australia. Such body was replaced in 2001 by the IASB.

[3] See Securities and Exchange Commission, Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 Arrangements with Off-Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers, June, 2005.

to real estate) and the FASB Interpretation No. 46 (R)(an interpretation of ARB 5 as it relates to consolidation of variable interest entities).

The New Standards

Topic 842 sets forth the lease accounting standards for both lessees and lessors under a dual-lease model. This represents a shift from the approaches taken under the FASB's 2010 Exposure Draft, *Leases (Topic 840)* and the 2013 Exposure Draft, *Leases (Topic 842)*. Responding to considerable feedback, the FASB modified its earlier approaches and adopted a lease accounting model that distinguishes between finance leases and operating leases generally relying on existing requirements to differentiate between the two types of leases. In addition, the FASB heeded the view of many respondents to such Exposure Drafts and left intact the existing lessor accounting model. For a complete understanding of the Final Standards, reference should be made to the actual Final Standards on the FASB.org website including the many illustrations following ASC 840-10-55-40 and the informative Background and Basis for Conclusions (the "BC") which appears on pages 334 to 484 thereof.

Lessee Accounting

It is with respect to the accounting by lessees of leases that the Final Standards have their most significant impact. With newly defined terms,[4] lessees now must recognize on balance sheet as a "Lease Liability" the present value of its unpaid "Lease Payments" under any "Lease" and show an offsetting asset on the balance sheet called a "Right-of-Use Asset".[5] However, lessees are given the option not to recognize Leases and corresponding assets for Lease with terms of twelve months or less. In such case, lessees will recognize the obligations under Leases as an expense generally on a straight-line basis over the lease term.[6] Below, this OnPoint will outline the difference between an Operating Lease and a Finance Lease, summarize "Lease Payments" and then summarize the effect of the Final Standards on income statements (statements of comprehensive income) and balance sheets (statements of financial position).

Classification as an Operating Lease or a Finance Lease

A "Lease" is a contract (or part of a contract) which conveys the right to control the use of identified property, plant and/or equipment for a period of time in exchange for consideration.[7] Once a Lease has been identified, the lessee thereunder must determine its classification. Utilizing a number of themes already existing in GAAP, the Final Standards describe the classification criteria for recognizing an operating lease and a finance lease. A lessee will classify a Lease as a "Finance Lease" if the Lease meets any of the following four criteria: (i) automatic transfer of underlying leased asset to lessee at the end of the term of the Lease, (ii) the lessee holds a purchase option with respect to such asset which the lessee is to exercise,[8] (iii) the term of the Lease exists

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[4] See generally the Glossaries following ASC 842-10-15-43, ASC 842-20-15-1 and ASC 842-30-15-1, as applicable (the "Glossaries"), for defined terms used and not otherwise defined herein.

[5] ASC 842-20-30-1

[6] Such leases are defined as Short-Term Leases. See Glossaries. The allowance for lessees to elect to treat Short-Term Leases as an expense is provided in 842-20-25-2. See also illustration thereof in 842-20-55-13.

[7] See ASC 840-10-15-2, *et. seq.* and ASC 840-10-55-1, Identifying a Lease.

[8] As more fully described in ASC 842-10-55-2. See also, ASC 842-10-55-26 for guidance on the economic factors which would be relevant in determining whether it would be reasonably certain that an option would be exercised.

for a “major part” of the remaining “Economic Life” of such asset, (iv) the present value of the sum of Lease Payments (as described below) and any residual value guaranty obligations (which are not already factored into the Lease Payments) equal or exceeds “substantially all of the “Fair Value” of such asset, or (v) such asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the expiry of the Lease.[9] When none of the foregoing criteria are satisfied, the lessee shall classify the Lease as an “Operating Lease”.[10] The criterion set forth in clause (i) above can also be met if the purchase price to be paid by lessee is a nominal amount.[11] The discount rate to be used in clause (iv) above shall be the rate which is implicit in the Lease unless such rate cannot be readily determined in which case the lessee shall use its incremental borrowing rate.[12] The criterion in clause (v) is new but logical due to the diminished likelihood that such property will be “controlled” by the lessor.

Calculation of Lease Payments

Lease Payments will consist of (i) fixed payments, (ii) variable lease payments which depend on an index or rate (CPI or a market interest rate),[13] (iii) the exercise price of an option to purchase if the lessee is reasonably certain to exercise such option, (iv) certain lease termination penalties and fee payments and, (v) for lessees only, amounts which are probable of being owed under residual value guarantees but will not include variable lease payments (other than those described above), guarantees by a lessee of the lessor’s debt and amounts which are related to any non-lease components which may be embedded in the lease contract.[14] For illumination on determination of reasonable certainty and of Lease Payments including in-substance fixed payments, guarantees, indemnifications and residual value guarantees, see Sections 842-10-55-26 and 842-10-55-30 through 40.

Effect on Income Statements

Under a Finance Lease, a lessee shall generally reflect on its income statement (i) amortization of the Right-of-Use Asset and interest which is imputed on the Lease Liability over the lease term (unless there is a bargain purchase option or an automatic transfer of ownership in the Finance Lease, in which case, over the life of the underlying asset), (ii) variable lease payments not already included in lease liability in the period in which such payment obligation is incurred, and (iii) any impairment in the Right-of-Use Asset.[15] The effect of the asset

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[9] ASC 842-10-25-2. See also, ASC 842-10-55-2 for additional guidance (but no “bright-line” tests) on assessing the criteria set forth in clauses (iii) and (iv) including utilization of FAS 13 analysis to reasonably conclude that seventy-five percent (75%) or more of the remaining economic useful life of the underlying asset would constitute a “major part” of the remaining Economic Life of such asset and that ninety percent (90%) or more of the fair value of such asset amounts to substantially all the fair value thereof.

[10] ASC 842-10-25-3.

[11] ASC 842-10-55-5.

[12] See Glossaries. See, generally, Lease Classification Test, BC 71 *et. seq.*

[13] Variable lease payments that depend on an index or rate will use the prevailing index or rate at the measurement date. Under GAAP, lessees will be required to reassess variable lease payments only when the liability is re-measured for other reasons (such as a change in the lease term), not when the index or rate change effects the payments actually being made. Under IFRS 16, lessees will need to reassess variable lease payments upon a change in the cash flow resulting from a change in the reference index or rate and when the lease liability is re-measured for other reasons.

[14] ASC 842-10-30-5, 842-10-30-6.

[15] ASC 842-20-25-5

amortization and imputed interest is to front-end load the costs of such Lease. Under an Operating Lease, a lessee shall generally reflect on its income statement, (i) a single lease cost, allocated over the lease term on a straight-line basis, in the absence of another rational basis and to the extent the Right-of-Use Asset has not been impaired, (ii) variable lease payments not already included in lease liability in the period in which such payment obligation is incurred, and (iii) any impairment in the Right-of-Use Asset.[16]

Effect on Balance Sheets

In the case of both Operating Leases and Finance Leases, an asset is created in favor of the lessee which is defined as a "Right-of-Use Asset." Such asset represents a lessee's right to use the leased property during the term of the lease and is recognized on the balance sheet of the lessee as an offsetting entry to its recognition of the liability created under the Lease.[17] Right-of-Use Assets under a Finance Lease and Right-of-Use Assets under an Operating Lease are reported separately.[18] A Right-of-Use Asset is measured initially based on its cost consisting of (i) the amount of the initial measurement of Lease Liability,[19] (ii) any Lease Payments made to the lessor on or prior to commencement of the lease minus any lease incentives received, and (iii) any initial direct costs incurred by the lessee.[20] After the initial recognition, a Right-of-Use Asset under a Finance Lease shall reflect accumulated amortization and accumulated impairment losses and the Lease Liability is amortized by increasing the carrying amount to reflect the imputed interest and decreasing such amount to reflect the Lease Payments made.[21] After the initial recognition, a Right-of-Use Asset under an Operating Lease shall reflect the then Lease Liability on a present value basis adjusted for prepaid or accrued Lease Payments, the remaining balance of any Lease incentives, unamortized initial costs and impairment of such asset.[22]

Debt or Non-Debt Operating Liability

As indicated above, under the Final Standards, lessees will continue to classify leases into two categories – Finance Leases and Operating Leases. Leases that were previously classified as capital leases will generally be classified as Finance Leases, and Operating Leases will generally continue to be classified as Operating Leases. The characterization is important because the FASB treats the liabilities discussed in the preceding paragraph differently: If the lease is a Finance Lease, such liability is treated as a debt liability which will be included in any debt related financial covenants or metrics used by lessee or its creditor.[23] However, if the

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[16] ASC 842-20-25-6. See also ASC 842-20-25-8 for a description of remaining costs under an Operating Lease.

[17] See Glossaries, ASC 842-20-25-1

[18] ASC 842-20-45-1

[19] The "Lease Liability" is the lessee's obligation to make Lease Payments pursuant to a Lease, measured on a discounted basis with the initial measurement equal to the present value of the Lease Payments not yet paid pursuant to ASC 842-20-30-1 and the discount rate being the implicit rate in the Lease or the lessee's incremental borrowing rate under ASC 842-20-30-2 through 4

[20] ASC 842-20-30-5 and ASC 842-20-30-9 and -10.

[21] ASC 842-20-35-1.

[22] ASC 842-20-35-3.

[23] BC 14.

lease is an Operating Lease, such liability is recognized as non-debt operating liabilities and, thus, not swept up into debt related calculations and metrics, and the leased property will not show as an asset of the lessee.[24]

Lease vs. Non-lease Components

For both Finance and Operating Leases, lessees will be required to separately account for lease and non-lease components including service components. However, recognizing the administrative burden of separating such components, the FASB permitted lessees to elect a “practical expedient” to combine such components and account for both as a Lease. It is expected by the FASB that lessees will generally only make this election in contracts with less significant non-Lease components.[25] With regard to lessors, the FASB concluded that accounting for lease components under Topic 842 and non-lease components under separate Topics (which they viewed to likely be Topic 606, Revenue Recognition) is consistent with existing guidance.[26]

Sale-Leaseback Transactions

The revised standards will have a substantial effect on sale-leaseback transactions, given that the transferor-lessee will no longer be permitted to move such asset and the related lease off-balance sheet. The determination of whether a sale has occurred will focus on which party has control of the underlying asset after the sale transactions are completed. The new lease guidelines rely on guidelines already in place for revenue recognition to ascertain whether the lessor has control.[27] Control under such revenue recognition guidelines indicate whether a person has the ability to direct the use of and obtain substantially all of the benefits of the asset. Such guidelines examine whether (i) the buyer has a present right to payment for the asset, (ii) legal title has been transferred to the purchaser/lessor, (iii) the purchaser/lessor has physical possession of the transferred asset, (iv) the buyer has the significant risks and rewards of ownership of such asset, and (v) the buyer has accepted the asset.[28] If a transferor-lessee retains control of the asset, then the transaction will be accounted for as a financing. Conversely, if control passes to the transferee-lessor, a sale will have occurred and should be accounted for as such. These rules put an effective end to sale-leaseback transactions where the lessee has a fixed price purchase option. In such transactions, the lessee will not recognize the transaction as a sale and an Operating Lease but as a Finance Lease. In contrast, fair market value purchase options should achieve sale and Operating Lease treatment. Leases with an early buyout option, if supported with independent diligence evidencing that the purchase price associated therewith is a reasonable estimate of the fair market value of the leased property at the time such option can be exercised, should also achieve sale and Operating Lease treatment.

Lessor Accounting

While lessors will not be unaffected by the new standards, lessors will continue to classify and account for leases much the same as they have prior to the adoption of the Final Standards. Based on reaction to both of the Exposure Drafts, the FASB decided that lessor accounting for leases under existing GAAP did not need a major overhaul and opted instead for an approach which, while largely symmetrical to lessee accounting for

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[24] *Id.*

[25] BC 148 through 150.

[26] BC 148

[27] ASC 842-40-25-1

[28] ASC 606-10-25-30

Leases (with definitions and classifications largely aligned), follows a "single unit of account" (that is, a net investment in the lease for sales-type and direct financing leases or by continuing to recognize the underlying asset for Operating Leases).[29] Lessors will continue to classify Leases as sales-type, direct financing or operating leases. In terms of classifications, to the extent a lessee would recognize a Lease as a Finance Lease, a lessor would recognize such Lease as a "Sales-Type Lease".[30] Similarly, when none of the criteria set forth in ASC 842-10-25-2 are met, a lessor will classify the Lease as an Operating Lease unless the following criteria are both met, in which case the lessor shall classify such Lease as a "Direct Financing Lease": (i) the present value of the sum of Lease Payments and any residual value guarantee payments which are not already counted under Lease Payments equals or exceeds substantially all of the fair value of the underlying asset, and (ii) it is probable that the lessor will collect lease payments plus any amount necessary to satisfy a "Residual Value Guarantee".[31] The discount rate to be used in clause (i) above shall be the rate which is implicit is the Lease.[32]

Transition Periods

The Final Standards will be effective for public companies for financial statements issued for fiscal years (including interim periods) beginning after December 15, 2018, while private companies will need to implement the new standards for financial statements issued for fiscal years beginning after December 15, 2019 with interim periods within fiscal years beginning after December 15, 2020. There are practical expedients with respect to the transition which are available to reporting entities and relate to reassessing existing leases.[33] The new standards will apply retroactively with the effect that all Leases (other than Short-Term Leases) will need to be shown on balance sheet with no grandfathering.

Effect on Future Leasing

From where the FASB lease project started and progressed along the way (*i.e., the Exposure Drafts*), the Final Standards are a relatively positive result. To many, recognizing leases on balance sheet directly rather through footnotes will provide a better understanding of lessee's leasing profile. The decision to retain a two lease model is also a welcomed development as the majority of respondents to the Exposure Drafts viewed such approach as a more accurate accounting of leasing. Although these standards are still very new and being digested by all in the leasing community, we have attempted to anticipate some of the effects of such standards on various leasing transactions going forward:

- The balance sheets of users of leases will expand as a result of the adoption of this Topic 842.
- Distinguishing between a Finance Lease and an Operating Lease is generally consistent with the current classifications of capital leases and operating leases

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[29] BC 90.

[30] ASC 842-10-25-2.

[31] ASC 842-10-25-3.

[32] ASC 842-10-25-4.

[33] ASC 842-10-65-1.

- The liability created by an Operating Lease will be a non-financial liability which will not be counted as debt for debt-related financial covenants. In addition to the higher advance rate typically given for leasing, and the hedge against obsolescence, this nuance should result in many lease users who are sensitive to such calculations to desire Operating Leases over Finance Leases and, more generally, over secured indebtedness.
- In addition, with the present value calculation of Lease Payments, lessees should gravitate toward Operating Leases if they wish to reduce their asset costs relative to secured indebtedness which is recognized without such present value approach.
- The effect of the Final Standards on sale-leaseback transactions with fixed price purchase options is unclear. While a fixed price which is demonstrated to equal the fair market value of the underlying leased asset on the exercise date, the fact that there exists any fixed price purchase option may be viewed as shifting control from the lessor to the lessee. While the control element is different from current guidelines, the assessment of the effect of a purchase option on the treatment of this transaction is an extension of the current analysis of continuing involvement by the transferor-lessee.
- Given the often used approach of low installments of rent and a higher residual value guarantee in synthetic lease transactions, relative to the treatment of other types of lease transactions and to the treatment of secured indebtedness, synthetic lease financings should have a low impact on the balance sheets of lessees. In build-to-suit financings, lessees should not have any recognition of the lease until substantial completion. Instead, they should account for their role as a service provider.
- The Final Standards provide clarity for users of Short-Term Leases. As well, the FASB provided helpful details regarding the treatment of variable lease payments and fixed payments was in such Standards.
- Accounting for Leases by lessors is largely intact with important exceptions. Lessors will account for Leases in a manner consistent with lessee accounting for Operating Leases and Finance Leases with financing arrangements being recognized as sales-type or direct financing leases. Third-party residual value insurance will be available as a device for lessors to change the treatment of Operating Leases to Finance Leases. While grandfathered, the FASB stuck to its prior position and eliminated lessors' use of the leveraged lease accounting approach.

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Dechert LLP is not an accounting firm nor are the persons who prepared this OnPoint accountants. Recipients hereof should consult with their accountants for advice on these and other accounting matters. In addition, the foregoing represents a summary of the Final Standards and is not and should not be construed to be financial or accounting advice.

Dechert's Lease Finance and Leasing Contacts:

Bruce D. Hickey
Partner, Boston
+1 617 654 8602
bruce.hickey@dechert.com

Lewis A. Burleigh
Special Counsel, Boston
+1 617 654 8601
lewis.burleigh@dechert.com

Francois Quintard-Morenas
Special Counsel, New York
+1 212 649 8754
francois.quintard-morenas@dechert.com

Linda Ann Bartosch
Associate, Philadelphia
+1 215 994 2132
lindaann.bartosch@dechert.com

Matthew C. Berg
Associate, New York
+1 212 641 5660
matthew.berg@dechert.com

Christopher Desmond
Associate, Boston
+1 617 728 7170
christopher.desmond@dechert.com

Stephanie L. Frank
Associate, Boston
+1 617 728 7117
stephanie.frank@dechert.com

Samuel H. Gilbert
Associate, Boston
+1 617 728 7137
sam.gilbert@dechert.com

Nitya Kumar Goyal
Associate, Philadelphia
+1 215 994 2165
nitya.goyal@dechert.com

Margot Mendelson Hammond
Associate, Boston
+1 617 728 7122
margot.hammond@dechert.com

Harrison A. Levy
Associate, Boston
+1 617 728 7112
harrison.levy@dechert.com

Paul M. McAleer
Associate, Philadelphia
+1 215 994 2775
paul.mcaleer@dechert.com

Colleen O'Connor
Associate, Boston
+1 617 728 7108
colleen.o'connor@dechert.com

Prerna Soni
Associate, New York
+1 212 649 8701
prerna.soni@dechert.com

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