Impact of New Lease Accounting Standard:
Beyond Your Balance Sheet

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Today's Presenters

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Learning Objectives

- **Review** key differences of the new lease accounting standard and discuss interplay with new revenue recognition standard
- **Analyze** examples of how the new standard will be accounted for by lessees
- **Develop** actionable steps your organization should be taking in preparation for the upcoming compliance deadlines

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Agenda

- **Review**
  - Background
  - Changes for Lessees
  - Changes for Lessors
  - Interplay with ASC 606
- **Analyze**
  - Definition of a Lease
  - Lease Decision Framework
  - Lease Accounting Steps
- **Develop**
  - Actionable Steps

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Review

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Background

- ASC Topic 842, *Leases,* issued February 2016 via ASU 2016-02
  + Will replace legacy guidance in ASC Topic 840
  + 10 years in the making
  + Came after joint FASB/IASB – ASC 606 / IFRS 15 Project

Key Objectives:

- Increase transparency regarding off balance sheet financing activities
- Expands qualitative and quantitative disclosures
- Intention is to enable financial statement users to assess the amount, timing, and uncertainty of cash flows from leases
- Enhanced disclosures include:
  - Nature of leases
  - Significant judgments and assumptions
  - Lease expense amounts
  - Maturity tables

Changes for Lessees

- Lessees will recognize both Operating and Finance (Capital) leases on the Balance Sheet
- Recognize a Right Of Use Asset and Lease Liability
- Retains concept of Operating vs. Finance (Capital)

Changes for Lessors

- Accounting applied by Lessors is largely unchanged from current GAAP
- Retains concept of operating leases versus finance (capital) leases
- Fewer leases will be classified as direct financing
- Fewer upfront costs (IDC) will qualify for deferral
- Unusual outcomes may result when sales-type leases contain primarily variable consideration

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Interplay with ASC 606 – Revenue From Contracts With Customers

- ASC 842 has many areas of crossover between, or direct references to, ASC 606.
  - For example, ASC 842 requires lessors to use the guidance in ASC 606-10-32-28 through 32-41 when separating, and allocating consideration to, the components in a contract.
- In addition, the guidance in ASC 606 on sales with a repurchase agreement may require suppliers to account for certain contracts with a customer within the scope of ASC 842.

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Polling Question #1

The correct answer for question #1 is…

- **All of the above**

Effective Dates

- Effective date for public business entities (PBE's) is fiscal years beginning after December 15, 2018 (effective starting January 1, 2019 for calendar year-end PBE's)
- Effective date for non-PBE's is fiscal years beginning after December 15, 2019 (effective starting January 1, 2020)
- Early adoption is permitted for all entities

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Scope Exceptions

- ASC Topic 842 applies to all **identifiable assets** except:
  - Leases to explore for or use minerals, oil, natural gas, and similar nonregenerative resources
  - Biological assets, including timber
  - Assets under construction
  - Intangible assets
  - Inventory

No scope exceptions for smaller leases (e.g., leases of low value assets such as personal computers or copiers)

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Analyze

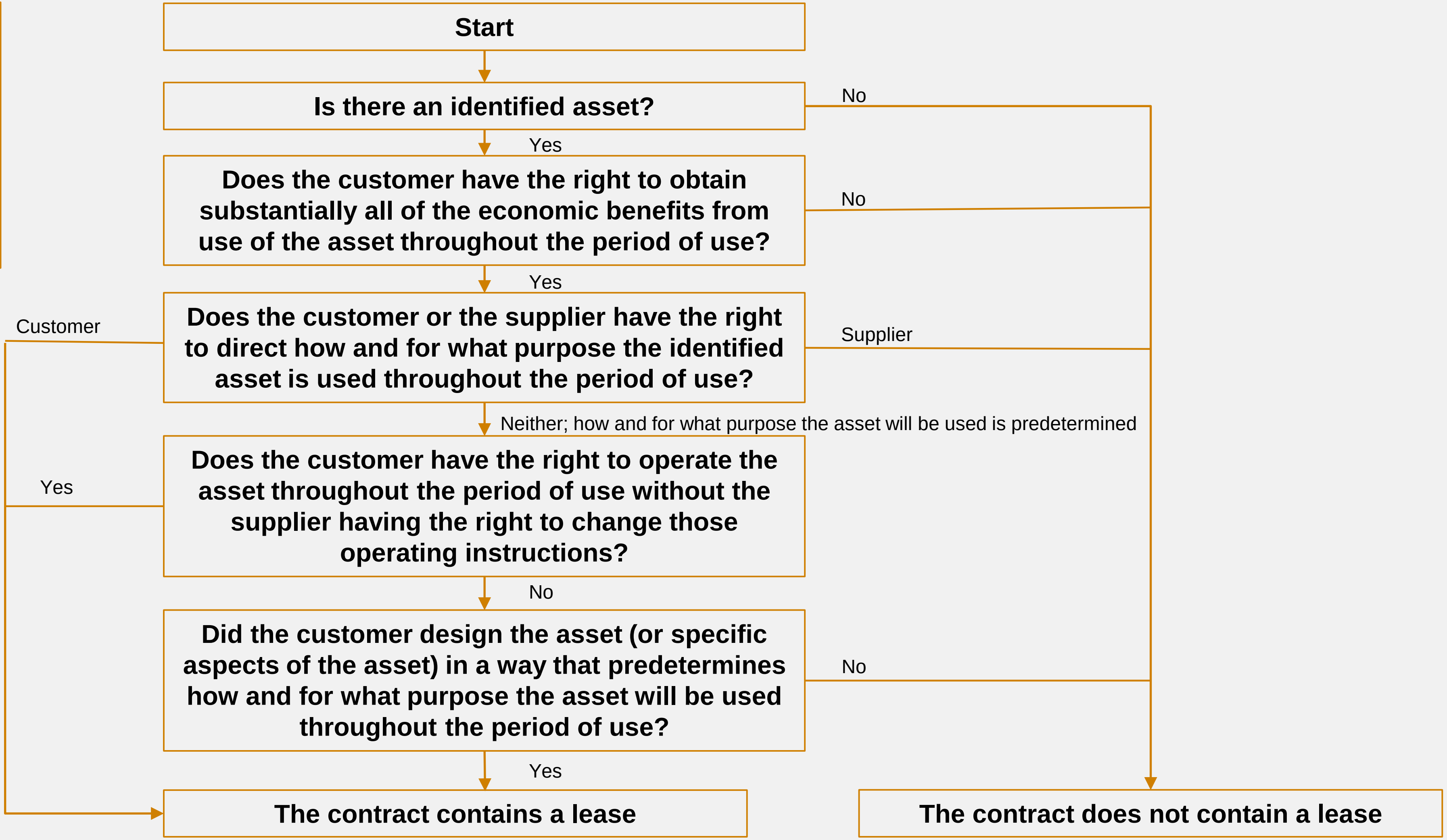
Definition of a Lease

"… a contract, or part of a contract, that conveys the right to control the use of identified property, plant, equipment (an identified asset) for a period of time in exchange for consideration"

- A contract is (or contains) a lease when two criteria are met:
  - The contract explicitly or implicitly specifies use of an **identifiable asset**
  - The customer **controls** the use of the asset for that <u>period of use</u>

Lease Decision Framework

The following flowchart is included in ASC 842's implementation guidance and depicts the decision-making process for determining whether an arrangement is or contains a lease.



Lease Accounting Steps

Identify Lease Term

Determine Lease Payments

- Identify lease and nonlease components
- Determine contract consideration
- Allocate consideration to lease and nonlease components

Calculate Discount Rate

Classify the lease (operating vs. finance)

Initial measurement and recognition

Subsequent accounting (reassessment, modification, impairment)

Identify Lease Term

- Lease term: Noncancelable period for which the lessee has the right to use the underlying asset, adjusted for:

Lessee-Controlled Options

- Extension / renewal period(s), if lessee is **reasonably certain** to extend
- Lease termination options, if lessee is **reasonably certain** to exercise (or not exercise)

Lessor-Controlled Options

- Assume that lessor will trigger the extension/renewal option
- Also assume that lessor will choose to not terminate the lease

Lessees permitted to not recognize lease assets and liabilities for short-term leases of 12 months or less

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Determine Lease Payments

Fixed payments, including
- **In-substance fixed payments**
- **Fixed amounts for property taxes and insurance**

Variable lease payments that depend on an index (e.g. CPI) or a rate

Lease incentives paid or payable to the lessee

The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to do so

Penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease

Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction

Amounts **probable** of being owed by the lessee under a residual value guarantee.

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Components of a Contract

Lease Components	▪ Right to use underlying asset ▪ Separate lease component when (a) usable on its own and (b) not dependent/interrelated with another right ▪ Land element ≠ separated if insignificant	Include in ROU asset and lease liability **(B/S)**
Nonlease Components	▪ Goods and services provided to the lessee by the lessor that are separate from the right to use the asset ▪ Examples: maintenance, paper and toner included in copier lease, cleaning services, security services, etc.	Executory contract - expense as incurred **(P/L)**
Items Outside the Lease (Not Components)	▪ Activities that do not transfer goods or services to the lessee ▪ Allocate to lease and nonlease components	Allocate to lease and nonlease components

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Lease Component Optional Election

- Lessees can elect an accounting policy to bundle a nonlease component with its related lease component
  - Election must be made by underlying asset class

Note:
Although this election can avoid estimating standalone selling prices for component allocation it increases initial right of use asset and lease liability at lease inception.

Calculate Discount Rate

Discount Rate

- Use **rate implicit in the lease**, but if that cannot be readily determined, use Lessee's **incremental borrowing rate**
- Incremental borrowing rate equals what a lessee would have to pay for a collateralized borrowing over a similar term as the lease
- Nonpublic business entity may elect to use a **risk-free discount rate** for all leases

Lease Classification - Lessee

- A lease that meets **any** of these criteria is a **finance lease:**

Ownership transfers to lessee by end of lease

Lessee is reasonably certain to exercise option to purchase the asset

Lease term is for major part of asset’s remaining economic life

PV (lease payments + residual value guaranteed by lessee) > substantially all of the FV of asset

Asset will have no alternative use to lessor at end of lease

Note:
Similar evaluation to ASC 840; however, bright lines (e.g. 90% NPV, 75% Useful Life) have been removed

Note:
A lease that meets none of these criteria is an operating lease

Polling Question #2

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The correct answer for question #2 is…

- **All of the above**

Finance Lease Accounting - Lessee

In a finance lease, Lessee will:

- **Amortize** the right-of-use asset on a straight-line basis over the lease term
- Record **interest expense** on the carrying value of the lease liability
- Reduce the carrying value of the lease liability as the lessee makes lease payments
- Record variable lease payments, if any, in the period incurred

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Operating Lease

In an operating lease, Lessee will:

- **Amortize the ROU asset over the lease term by the difference between the straight-line lease expense and the lease liability accretion**
  - Straight-line lease expense = the sum of the undiscounted lease payments and initial direct costs, divided by the lease term
- Reduce the carrying value of the lease liability as the lessee makes lease payments
- Record variable lease payments, if any, in the period

Initial Measurement And Recognition – Lessee

- Lessees will recognize a lease liability and right of use asset at lease commencement

Lease Liability

- PV of lease payments not yet made, discounted at:
  - \+ Implicit rate in the lease, or
  - \+ Lessee's incremental borrowing rate if implicit rate in the lease is not readily determinable

Right of Use Asset

- ROU Asset @ Initial Measurement
  Lease liability, adjusted for:
  - \+ Initial direct costs incurred by the lessee
  - \+ Prepayments of lease payments
  - \- Receipts of lease incentives

Note: Lease liability will likely <u>not</u> equal ROU Asset @ Initial Measurement

Finance Lease – Lessee Example

Finance Lease - Example

Background Information:

- 3 year lease
- Lease payments
  - $100K year 1
  - $105K year 2
  - $110K year 3
- $35K IDC's
- Discount Rate = 7%

Day 1 Calculations:

- Lease Liability = $274,962 (NPV of $100K + $105K + $110K @ 7% Discount)
- Right Of Use Asset = $309,962 = $274,962 (Lease Liability) + $35K (IDC's)
- ROU Asset Amortization = $103,321 = $309,962 ROU Asset divided by 3 year lease term

Day 1 – JE:

Dr: ROU Asset	$309,962	
Cr: Cash For IDC's		$35,000
Cr: Lease Liability		$274,962

Finance Lease Example

Year	Right Of Use Asset			Lease Liability			
	Begin. Balance	Amort'n	Ending Balance	Begin. Balance	Interest @ 7.0%	Payments	Ending Balance
1	309,962	(103,321)	206,641	274,962	19,247	(100,000)	194,209
2	206,641	(103,321)	103,321	194,209	13,595	(105,000)	102,804
3	103,321	(103,321)	-	102,804	7,196	(110,000)	-

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Finance Lease Example – Journal Entries

In Year 1:

Dr. Interest Expense	$19,247
Dr. Lease Liability	$80,753
Cr. Cash	$100,000

Interest expense = $274,962 opening lease liability x 7% discount rate

Dr. Amortization expense	$103,321
Cr. Right of Use Asset	$103,321

Amortization expense = $309,962 ROU asset divided by 3-year lease term

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Finance Lease Example – Summary

	Year 1	Year 2	Year 3	Total
Interest	19,247	13,595	7,196	40,038
Amortization	103,321	103,321	103,321	309,962
Total Expense	122,568	116,915	110,517	350,000

	Year 1	Year 2	Year 3	Total
Operating Cash Flows	(54,247)	(13,595)	(7,196)	(75,038)
Financing Cash Flows	(80,753)	(91,405)	(102,804)	(274,962)
Total Cash Flows	(135,000)	(105,000)	(110,000)	(350,000)

Note: Finance Lease – Expense front-loaded in early years. Reduction in lease liability is Financing Cash Flow activity.

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Polling Question #3

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The correct answer for question #3 is…

- **Present value of future lease payments discounted at appropriate discount rate**

Operating Lease – Lessee Example

Operating Lease - Example

Background Information:

- 3 year lease
- Lease payments
  - $100K year 1
  - $105K year 2
  - $110K year 3
- $35K IDC's
- Discount Rate = 7%

Day 1 Calculations:

- Lease Liability = $274,962 (NPV of $100K + $105K + $110K @ 7% Discount)
- Right Of Use Asset = $309,962 = $274,962 (Lease Liability) + $35K (IDC's)
- ROU Asset Amortization = $116,667 = $350,000 ($100K + $105K + $110K + $35K) divided by 3 year lease term
  - To be netted with Lease Accretion each year ($19,247 Yr. 1, $13,595 Yr. 2, $7,196 Yr. 3) to reduce the ROU Asset

Day 1 – JE:

Dr: ROU Asset	$309,962	
Cr: Cash For IDC's		$35,000
Cr: Lease Liability		$274,962

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Operating Lease Example

Year	Right Of Use Asset				Lease Liability			
	Begin. Balance	SL Amort'n	Accretion	Ending Balance	Begin. Balance	Interest @ 7.0%	Payments	Ending Balance
1	309,962	(116,667)	19,247	212,542	274,962	19,247	(100,000)	194,209
2	212,542	(116,667)	13,595	109,470	194,209	13,595	(105,000)	102,804
3	109,470	(116,667)	7,196	-	102,804	7,196	(110,000)	-

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Operating Lease Example – Journal Entries

In Year 1:

Dr. Rent Expense	$19,247
Dr. Lease Liability	$80,753
Cr. Cash	$100,000

Lease Accretion = $19,247 = $274,962 opening liability x 7% discount (unwinding of discount)

Dr. Rent Expense	$97,419
Cr. ROU Asset	$97,419

Reduction to ROU Asset = $97,419 = $116,667 Straight-Line Amort. - $19,247 Lease Accretion

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Operating Lease Example – Summary

	Year 1	Year 2	Year 3	Total
Accretion	19,247	13,595	7,196	40,038
Amortization	97,419	103,072	109,470	309,962
Total Expense	116,667	116,667	116,667	350,000
	Year 1	**Year 2**	**Year 3**	**Total**
Operating Cash Flows	(135,000)	(105,000)	(110,000)	(350,000)
Financing Cash Flows	-	-	-	-
Total Cash Flows	(135,000)	(105,000)	(110,000)	(350,000)

Note: Operating Lease – Expense is same throughout periods. All Operating Lease activity is Operating Cash Flow activity.

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Optional Transition Method

- Lease standard as originally approved requires companies to apply modified retrospective approach for the two preceding years and issue two years of comparative reporting
  - A public company adopting on January 1, 2019 was required to show comparative information starting January 1, 2017
- FASB recently voted to create a new, optional transition method for lessees
  - Allows companies to forgo the comparative reporting requirements
  - A public company adopting on January 1, 2019 will recognize a cumulative-effect adjustment to the opening balance sheet of retained earnings on the adoption date rather than on January 1, 2017

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Develop

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Actionable Steps

- Assess existing leases and their impacts on the business
- Examine for embedded leases in service contracts
- Update lease inventory
- Evaluate impact to financial statements
- Evaluate impact to financial ratios and metrics and debt covenants
- Assess internal controls and policies over lease accounting
- Consider adequacy of software

CFO Considerations

- What are my key areas of risk?
- How many leases do we have?
- Have we identified data needs, ability to extract key data, and how we might re-calculate?
- Will we need to adjust our business processes and behaviors?
- Will we need to implement applicable technology or modify existing systems?
- Do we have enough time to do this ahead of the deadline?
- Do we have qualified internal resources to do this work?
- Should we designate a project manager/lease liaison (internal vs external)?
- Have we reached out to our auditors?
- Who are the right partners to help us get this done right?

Polling Question #4

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The correct answer for question #4 is…

In Conclusion

- During this webinar we have:
  - **Reviewed** key differences of the new lease accounting standard and discuss interplay with new revenue recognition standard
  - **Analyzed** examples of how the new standard will be accounted for by lessees
  - **Developed** actionable steps your organization should be taking in preparation for the upcoming compliance deadlines

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