ACCOUNTING STANDARDS UPDATE 2016-02, LEASES

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AGENDA

- Introduction
- Scope and Identifying a Lease
- Lease Classification, Terms, and Payments
- Lessee Accounting
- Financial Statement Presentation
- Transition

INTRODUCTION

- **ASU 2016-02, *Leases (Topic 842)* issued February 2016**
- **Dual approach for lessees and lessors**

- **Effective dates (early adoption permitted):**

Public Business Entities	All Other Entities
FYs beginning after 12/15/18 (and interim periods within)	FYs beginning after 12/15/19 (interim periods within FYs beginning after 12/15/20)

SCOPE

- **Applies to all leases and subleases, except:**
  - Leases of intangible assets (Topic 350)
  - Leases for exploration or use of certain natural resources (Topics 930 & 932)
  - Leases of biological assets (Topic 905)
  - Leases of inventory (Topic 330)
  - Leases of assets under construction (Topic 360)
- **Scope exception for short-term leases (term less than 12 months)**
- **Separation of non-lease components**

IDENTIFYING A LEASE

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

Determine at inception based upon:

- Whether contract fulfillment depends on use of an *identified asset* (consider whether supplier has substantive right of substitution)
- Whether contract conveys right to control use of identified asset for consideration for a time period.

IDENTIFYING A LEASE

- **Right to control use of the identified asset depends upon:**
  - Right to obtain economic benefits from the use of the identified asset (e.g., through using, holding, or subleasing the asset).
    - "Economic benefits" is fairly broad
    - Consider within defined scope of customer's contractual right to use the asset
  - Right to direct the use of an identified asset. This exists when customer has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.

IDENTIFYING A LEASE

- **Customer enters into a 5-year contract with a warehousing company for the right to use three specified, physically distinct storage units.**

- **Customer makes all of the decisions about the use of the facilities (subject to certain legal considerations).**

- **The arrangement contains a lease.**

IDENTIFYING A LEASE

- **Customer enters into a 5-year contract with a warehousing company (Supplier) to store goods within the Supplier's portfolio of buildings.**

- **The specified amount is equivalent to Customer having the use of the full capacity of three stand-alone storage units.**

- **The arrangement does NOT contain a lease.**

SHORT-TERM LEASES

Two criteria for short-term leases:

- Lease term of 12 months or less
- No option to purchase underlying asset that lessee is reasonably certain to exercise

If short-term lease, lessee can elect not to apply recognition requirements (no balance sheet gross-up for ROU asset and related lease liability)

- Recognize lease payments in P&L on straight-line basis
- Recognize variable lease payments as they are incurred

Accounting policy must be made by class of underlying asset and be disclosed

LEASE CLASSIFICATION

- **Right of use model – recognize ROU asset and lease liability at inception for all leases**
  - Optional exemption for leases with terms < 12 months
- **Classify all leases as finance or operating (5 criteria)**
  - Finance lease – lessee effectively obtains control of underlying asset
  - Operating lease – lessee does not effectively obtain control of underlying asset
- **Similar balance sheet impact; different income statement and cash flow results**

LEASE CLASSIFICATION

Five criteria for finance lease:

1. **Transfer of ownership of underlying asset to lessee by end of lease term**
2. **Option to purchase underlying asset that lessee is reasonably certain to exercise**
3. **Lease term = major part of remaining economic life of underlying asset**
4. **Sum of PV lease payments and PV any residual value guaranteed by lessee ≥ substantially all of the FV of underlying asset**
5. **Underlying asset is of such a specialized nature that it is expected to have no alternative use to lessor at end of lease term**

If one or more of the above are met, classify as finance lease.

LEASE TERM AND PAYMENTS

Two elements form basis for PV of lease payments

Lease Term

- Estimated as the non-cancellable period of the lease
- Include periods under option to extend IF lessee is *reasonably certain* to exercise option
- Include periods under option to terminate IF lessee is *reasonably certain NOT* to exercise option
- Same analysis for purchase options

Lease Payments

- Fixed lease payments (less incentives to be paid by lessor)
- Variable payments tied to an index
- Variable payments which are in-substance fixed payments
- Residual value guarantees (probably amount)
- Exercise price of purchase option IF lessee is *reasonably certain* to exercise option
- Termination penalties IF lease term reflects lessee exercising option
- Fees paid to structure an SPE

LEASE TERM

- ***Reasonably certain*** **is a high threshold substantially the same as** ***reasonably assured*** **in existing U.S. GAAP.**
    - Includes assessment of economic incentives.
- **Reassess the lease term only upon the occurrence of a significant event or change in circumstances that are within the control of the lessee.**

LEASE PAYMENTS

- **Variable payments:**
  - Day 1 – include index-based payments (e.g. CPI escalator) measurement based on the rate at commencement.
  - Day 2 – only reassess when the lease liability is reassessed for other reasons (e.g. contract modification). Otherwise, changes in the index are period expenses.
- **In-substance fixed payments are included in Day 1 lease liability, consistent with current practice.**
- **Discount rate – use the rate implicit in the lease if determinable, otherwise use incremental borrowing rate.**
  - Nonpublic entities – policy election to use risk-free rate

LEASE TERM AND PAYMENTS

- **Retailer enters into a 5-year lease agreement with a mall operator that includes three 5-year renewal options. Rent payments are $1,000/month plus 1% of sales during the initial term, with base rent growing 10% in each renewal period.**
- **Retailer incurs costs of $100,000 installing leasehold improvements to customize space to its brand requirements. LHI has a useful life of 8 years.**
- **The existence of significant leasehold improvements with useful lives longer than the base lease term indicates that Retailer would incur an economic loss from not exercising the first renewal option.**

Lease term is 10 years, base term plus one renewal period.

- **Percentage rent is variable, and thus is not included in lease payments. Instead, expensed as incurred.**

Lease payments total $126,000 ($60k for base + $66k for renewal).

INITIAL DIRECT COSTS

Include:

- **Commissions**
- **Payments made to an existing tenant as an incentive to terminate its lease**

Do not include costs to negotiate or arrange a lease that would have been incurred regardless of whether the lease was obtained, such as:

- **General overhead costs**
  - Examples: depreciation, occupancy and equipment costs, unsuccessful origination efforts, and idle time
- **Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases, or other ancillary activities**
- **Costs related to activities that occur before the lease is obtained**
  - Examples: costs of obtaining tax or legal advice, negotiating lease terms and conditions, or evaluating a prospective lessee's financial condition

MULTIPLE ARRANGEMENTS

- **Contract combinations: multiple contracts should be combined when entered into with the same counterparty if:**
  - The contracts are negotiated as a package
  - The price in one depends on the other
  - Underlying assets conveyed by the contracts are a single lease component
- **Conversely, if one contract contains multiple assets, it should be separated out into multiple lease components if:**
  - The lessee can benefit from the right to use each asset on its own and is not highly dependent on nor highly interrelated with the other assets in the contract.

MULTIPLE ARRANGEMENTS

- **Non-lease components: if an arrangement contains both lease and non- lease components, they must be accounted for separately**
  - Lessees can elect a practical expedient to combine and account for the non-lease components as part of the contract
    - Electing the practical expedient is an accounting policy election and is made by class of the underlying assets. So, you could elect the practical expedient for leases of some types of assets and not others.
  - If the lessee choses not to elect the practical expedient, the lessee should separate the lease and non-lease components on a relative standalone selling price basis

MULTIPLE ARRANGEMENTS

- **Example of a contract containing both lease and non-lease components where the practical expedient is not elected:**
  - Facts:
    - Lease is for one truck
    - Payment is $1,100 per month
    - Lease term is 7 year (84 months)
    - Regularly scheduled maintenance is included in the lease (specific maintenance included is defined in the lease)
    - Lessee is responsible for finding and maintaining insurance on the truck
    - Lessee is responsible for any maintenance not defined in the lease

MULTIPLE ARRANGEMENTS

- **Example of a contract containing both lease and non-lease components where the practical expedient is not elected:**
  - Lessee must determine standalone costs of the lease and non-lease components.
    - Lessee determines it can lease the truck without the maintenance for $1,000 per month
    - Lessee determines it can enter a similar maintenance contract for $150 per month

MULTIPLE ARRANGEMENTS

- **Example of a contract containing both lease and non-lease components where the practical expedient is not elected:**

	Standalone Price		Relative Standalone Price	
Truck Lease	$84,000		$80,348	
Maintenance	12,600		12,052	
	$96,600		$92,400	

LESSEE ACCOUNTING

INITIAL MEASURMENT

Right-of-use asset

- Present value (PV) of lease payments + lessee's initial direct costs
- Initial direct costs: Incremental costs directly attributable to an obtained lease
- Recognize lease incentives as a reduction in the right-of-use asset

Lease liability (LL)

- PV of lease payments
- Private company practical expedient - use risk-free rate to measure LL

LESSEE ACCOUNTING

SUBSEQUENT MEASUREMENT

Right-of-use asset

- Amortized cost: Method of amortization depends on lease classification (finance or operating)
- Impairment: Refer to existing standards (ASC 360)

Lease liability

- Amortized cost: Use the effective interest method
- Private company practical expedient - use risk-free rate to measure LL

LESSEE ACCOUNTING EXAMPLE

Facts:

- **10-year lease, option to extend 5 years**
- **LP = $50K/year (initial term); $55K/year (optional period)**
- **Not reasonably certain to exercise option to extend, therefore, lease term = 10 years**
- **Payments due at beginning of each year**
- **Initial direct costs (IDC) = $15K**
- **Lessee's incremental borrowing rate = 5.87%**
- **PV of remaining LP after payment of 1st year rental & IDC = $342,017**

Right-of-use asset	407,017	
Lease liability		342,017
Cash (lease payment for year 1)		50,000
Cash (initial direct costs)		15,000

LESSEE ACCOUNTING EXAMPLE

Journal entry to recognize lease expense during 1st year, <u>if finance</u>:

Interest expense	20,076 [1]	
Lease liability		20,076
Amortization expense	40,702 [2]	
Right-of-use asset		40,702

1. **Calculated as (5.87% x 342,017) (effective interest method)**
2. **Calculated as (407,017 / 10) (straight-line amortization)**

Results in higher expense at the front end of a lease due to higher interest expense

LESSEE ACCOUNTING EXAMPLE

Journal entry to recognize lease expense during 1st year, <u>if operating</u>:

Lease expense	51,500 [1]	
Lease liability		20,076 [2]
Right-of-use asset		31,424 [3]

1. **Calculated as [(500,000 + 15,000) / 10) (straight-line expense)**
2. **Calculated as (5.87% x 342,017) (effective interest method)**
3. **Calculated as (51,500 – 20,076)**

Results in flat expenses over the term of the lease – trade-off between higher interest expense on the front end and higher asset amortization on the back-end

FINANCIAL STATEMENT PRESENTATION

Balance Sheet – All Leases:

- Present separately or within similar classes of assets and liabilities with proper disclosure (no co-mingling of finance and operating leases)

Income Statement – Finance Leases:

- Display interest on lease liability and amortization of ROU asset consistently with other interest and amortization expenses

Income Statement – Operating Leases:

- Display interest on lease liability together with amortization of ROU asset, within income from continuing operations

FINANCIAL STATEMENT PRESENTATION

Statement of Cash Flows:

- Operating Activities:
  - Interest on lease liability arising from finance lease
  - Payments arising from operating leases
  - Variable lease payments and short-term lease payments not included in lease liability
- Financing Activities:
  - Principal repayments on finance leases

TRUCKING COMPANY, LLC
BALANCE SHEETS

ASSETS

		BEFORE	AFTER
Current assets:			
Cash and cash equivalents		$ 500,000	$ 500,000
Accounts receivable - trade		1,000,000	1,000,000
Prepaid expenses and other current assets		100,000	100,000
Total current assets		1,600,000	1,600,000
Property and equipment, net	**FINANCE LEASES**	2,000,000	2,000,000
Right-of-use assets	**OPERATING LEASES**	-	407,017
		$ 3,600,000	$ 4,007,017

LIABILITIES AND STOCKHOLDER'S EQUITY

		BEFORE	AFTER
Current liabilities:			
Accounts payable - trade		$ 750,000	$ 750,000
Accrued expenses		200,000	200,000
Current portion of long-term debt	**FINANCE LEASES**	500,000	500,000
Current portion of lease obligations	**OPERATING LEASES**	-	67,836
Total current liabilities		1,450,000	1,517,836
Long-term debt	**FINANCE LEASES**	1,500,000	1,500,000
Lease obligations	**OPERATING LEASES**	-	339,181
Stockholder's equity:			
Common stock		10,000	10,000
Retained earnings		650,000	650,000
Total stockholder's equity		660,000	660,000
		$ 3,610,000	$ 4,017,017

TRUCKING COMPANY, LLC
COMBINED STATEMENTS OF INCOME

		BEFORE	AFTER
Operating revenues		$ 5,000,000	$ 5,000,000
Operating expenses and costs:			
Salaries, wages and benefits		2,000,000	2,000,000
Operating supplies and expenses		1,400,000	1,400,000
Operating taxes and licenses		75,000	75,000
Insurance and claims		200,000	200,000
Communications and utilities		50,000	50,000
Depreciation and amortization	**FINANCE LEASES**	750,000	750,000
Rent and purchased transportation	**OPERATING LEASES**	250,000	250,000
		4,725,000	4,725,000
Operating income		275,000	275,000
Other income (expense):			
Interest expense	**FINANCE LEASES**	(75,000)	(75,000)
Interest income		4,000	4,000
Other, net		500	500
		(70,500)	(70,500)
Net income		$ 204,500	$ 204,500

TRUCKING COMPANY, LLC
COMBINED STATEMENTS OF CASH FLOWS

	BEFORE	AFTER
Cash flows from operating activities:		
Net income	$ 204,500	$ 204,500
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	750,000	750,000
Changes in assets and liabilities:		
Accounts receivable - trade	(350,000)	(350,000)
Prepaid expenses and other current assets	(25,000)	(25,000)
Accounts payable - trade	(300,000)	(300,000)
Accrued expenses	75,000	75,000
Net cash provided by operating activities	354,500	354,500
Cash flows from investing activities:		
Purchases of property and equipment	(1,500,000)	(1,500,000)
Proceeds from sale of property and equipment	1,000,000	1,000,000
Net cash used in investing activities	(500,000)	(500,000)
Cash flows from financing activities:		
Proceeds from borrowings of long-term debt	1,500,000	1,500,000
Repayments of borrowings of long-term debt	(1,000,000)	(1,000,000)
Net cash provided by financing activities	500,000	500,000
Net change in cash	354,500	354,500
Cash - beginning of year	145,500	145,500
Cash - end of year	$ 500,000	$ 500,000

HOW TO STRUCTURE NEW LEASES: OPERATING OR FINANCE?

- **Both Operating and Finance leases will now go on the Balance Sheet – no longer a motivation**
- **Finance leases will result in higher Income from Operations and EBITDA since the lease payments are allocated between depreciation and interest expenses**
- **Finance leases will result in higher Cash Flows from Operations since the principal portion of payments is presented as a part of financing activities**

TRUCKING COMPANY, LLC
COMBINED STATEMENTS OF INCOME

		FINANCE	OPERATING
Operating revenues		$ 5,000,000	$ 5,000,000
Operating expenses and costs:			
Salaries, wages and benefits		2,000,000	2,000,000
Operating supplies and expenses		1,400,000	1,400,000
Operating taxes and licenses		75,000	75,000
Insurance and claims		200,000	200,000
Communications and utilities		50,000	50,000
Depreciation and amortization	**FINANCE LEASES**	750,000	700,000
Rent and purchased transportation	**OPERATING LEASE**	250,000	305,000
		4,725,000	4,730,000
Operating income		275,000	270,000
Other income (expense):			
Interest expense	**FINANCE LEASES**	(75,000)	(70,000)
Interest income		4,000	4,000
Other, net		500	500
		(70,500)	(65,500)
Net income		$ 204,500	$ 204,500
EBITDA		$ 1,029,500	$ 974,500

TRUCKING COMPANY, LLC
COMBINED STATEMENTS OF CASH FLOWS

	FINANCE	OPERATING
Cash flows from operating activities:		
Net income	$ 204,500	$ 204,500
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	750,000	700,000
Changes in assets and liabilities:		
Accounts receivable - trade	(350,000)	(350,000)
Prepaid expenses and other current assets	(25,000)	(25,000)
Accounts payable - trade	(300,000)	(300,000)
Accrued expenses	75,000	75,000
Net cash provided by operating activities	354,500	304,500
Cash flows from investing activities:		
Purchases of property and equipment	(1,500,000)	(1,500,000)
Proceeds from sale of property and equipment	1,000,000	1,000,000
Net cash used in investing activities	(500,000)	(500,000)
Cash flows from financing activities:		
Proceeds from borrowings of long-term debt	1,500,000	1,500,000
Repayments of borrowings of long-term debt	(1,000,000)	(950,000)
Net cash provided by financing activities	500,000	550,000
Net change in cash	354,500	354,500
Cash - beginning of year	145,500	145,500
Cash - end of year	$ 500,000	$ 500,000

TRANSITION

Lessee & lessor transition

- **Modified retrospective approach with hindsight allowed for evaluating renewal and purchase options on existing leases. No option for full retrospective.**
- **Significant relief provisions allowed as a policy election – No reassessment of:**
  - Whether any expired or existing contracts are or contain leases
  - Classification for any expired or existing leases
  - Initial direct costs for expired or existing leases
  - Leveraged lease treatment grandfathered

TRANSITION

Developing a plan to transition, including impacts on:

- **ICFR**
- **Planning and budgeting**
- **Taxes**
- **Compensation arrangements**
- **Debt covenants and other contracts**
- **Internal and external communication**
- **IT systems/data management**
- **Lease structure strategy**

QUESTIONS?