Overview of Lease Accounting: ASC Topic 842, Leases

Bret Rutter, Partner
Scott Swearingen, Partner
Moss Adams LLP
The material appearing in this presentation is for informational purposes only and should not be construed as advice of any kind, including, without limitation, legal, accounting, or investment advice. This information is not intended to create, and receipt does not constitute, a legal relationship, including, but not limited to, an accountant-client relationship. Although this information may have been prepared by professionals, it should not be used as a substitute for professional services. If legal, accounting, investment, or other professional advice is required, the services of a professional should be sought.
Agenda

Scope, Accounting Model and Key Terms
Recognition and Measurement
Presentation and Disclosure
Effective Date and Transition
Why Change?

FASB has said:

**Lessees**
- Most lease are off-balance sheet
- Disclosures provide only limited information about operating leases

**Lessors**
- Lack of transparency about residual values
- Consistency with lessee proposal and revenue recognition proposal

---

$1.25 trillion
Of off-balance sheet operating lease commitments for SEC registrants*

* Estimate according to the 2005 SEC report on off-balance sheet activities
Scope & Accounting Model
Right-of-Use Model

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

<table>
<thead>
<tr>
<th>Identified asset</th>
<th>The contract explicitly or implicitly specifies the use of identified property, plant, or equipment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer control</td>
<td>The customer controls the use of the identified asset for a period of time.</td>
</tr>
</tbody>
</table>
Does the Contract Contain a Lease?

**IDENTIFIED ASSETS**
- Explicitly or implicitly identify leased asset
- Supplier has no practicable ability to substitute and would not economically benefit from substitution

**RIGHT TO CONTROL**
- Decision-making authority to direct the use of the identified asset
- Ability to obtain substantially all of the economic benefit from the use of the asset
Implementation Guidance

ASC 842-10-55-1

Flowchart depicting the how to determine whether a contract is or contains a lease.
Does the Contract Contain a Lease?

**EXAMPLE**

- Builders, Inc., a general contractor, enters into a 2-year contract with Crane Co. to provide a tower crane for a large project.
- Contract also requires Crane Co. to provide a crane operator to run the crane.
- While subcontractors may schedule lifts directly with Crane Co., Builder has final say as to when, where, and which items will be lifted by the crane.
- Crane Co. is obligated to provide suitable replacement if the crane becomes inoperable for an extended period of time.
Does the Contract Contain a Lease?

EXAMPLE

The contract contains a lease of the crane

- The crane is implicitly specified in the contract
- Once delivered to Builder, it is impracticable to substitute the crane unless it becomes inoperable for an extended period of time
- Builder has the right to control the use of the crane throughout the contract:
  - Builder has the right to obtain substantially all of the economic benefits of the crane
  - Builder has the right to direct the use of the crane
- The crane operator is a nonlease component
FASB’s Dual Model

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th>Income Statement</th>
<th>Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>Amortization expense</td>
<td>Financing cash flow for principal</td>
</tr>
<tr>
<td>Lease liability</td>
<td>Interest expense</td>
<td>Operating cash flow for all other</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Finance</th>
<th>Operating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Right-of-use asset</td>
<td>Single lease expense on a straight-line basis</td>
</tr>
<tr>
<td>Lease liability (not debt)</td>
<td>Operating cash flow for all lease payments</td>
</tr>
</tbody>
</table>

Recognition and measurement option for short-term leases.
## Finance Lease Criteria for Lessee

If lease doesn’t meet these criteria, then it’s an operating lease

- Assess at lease commencement not lease inception
- Reasonably certain is a high threshold - Consider contract, asset, market, and entity based criteria
- Lease term – consider all options reasonably certain to be exercised
- 3rd criteria not applicable when lease entered into near end of assets economic life

<table>
<thead>
<tr>
<th>Transfer of ownership by end of lease term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase option that is “reasonably certain” to be exercised</td>
</tr>
<tr>
<td>Lease term is for “major part” of remaining economic life</td>
</tr>
<tr>
<td>PV of lease payments plus any RVG equals or exceeds “substantially all” of the asset’s fair value</td>
</tr>
<tr>
<td>Asset is of such specialized nature that only lessee can use it without major modifications</td>
</tr>
</tbody>
</table>
Key Terms
Focus on Key Terms

Under ASC 840, classification was one of the more important aspects of lease accounting since the results determined whether a lease was recognized on the balance sheet.

Since most leases under ASC 842 are recognized on the balance sheet, classification could become less of a factor making these key terms more relevant to the classification and measurement of amounts recognized.
Lease Term

Classification & Measurement

• Assess at lease commencement and reassess only upon changes that are in lessee’s control
• Factors to consider:
  – *Contract* has penalty for failure to renew
  – *Asset* is critical to operations
  – *Entity* performed significant integration
  – Below *market* option

Lessee’s options to purchase, extend, or terminate the lease when *reasonably certain*

Lessor’s options to extend (or not terminate the lease)

Assessment of *reasonably certain* to consider all factors
Nonlease Components

Allocate consideration to lease vs. nonlease components

- Nonlease components include goods and services provided to the lessee separate from the right to use the leased asset. For example:
  - Supplies, consumables, & disposables
  - CAM and janitorial
  - Service and support
  - Operators
- Lessors apply ASC Topic 606 to nonlease components.

Observable stand-alone prices

Estimate if not readily available

Accounting policy election to treat as single lease component
Are there Nonlease components?

**EXAMPLE**

- Lessor, Inc. owns and operates a business park comprised of several commercial office buildings
- Lessor enters into a five-year lease with Tenant Co. for use of one building, including designated parking lot and surrounding grounds
- Monthly lease payments are fixed at $4,000/month
- Tenant Co. is required to separately pay taxes and insurance on the building
- Lessor, Inc. is required to perform common maintenance services such as cleaning the parking lot, mowing the grass, watering plants, window cleaning, etc.
Are there Nonlease components?

EXAMPLE

Two components exist

1. The right to use the building (lease component)
2. The common area services (nonlease component)

• CAM is a nonlease component because it provides a service to Tenant separate from the right to use the building, which Tenant would need to pay for separately if not included in the contract

• Taxes and insurance are not separate components because they do not represent payments for goods and services other than the right to use the building

• Bifurcate lease payments based on stand alone selling prices of the lease and nonlease components
  – Taxes and Insurance are excluded from the lease payment because they are variable payments not based on an index or rate
Lease Payments

Classification & Measurement

• Include in-substance fixed payments
• Option and termination penalty payments aligned with lease term conclusions
• Include only those variable lease payments based on an index or rate (e.g. CPI) at lease commencement
• Generally exclude taxes, insurance, and other lessor costs paid by lessee that are not based on index or rate

Fixed payments less incentives paid or payable to lessee
Exercise price of options
Penalty payments
Residual value guarantees that are probable
Variable payments based on index or rate included
Discount Rate

Lease-by-lease basis

Implicit rate can be calculated if the FV of the leased asset, the periodic payments due under the lease, and the lessor’s expected residual value for the leased asset are all known to the lessee at lease commencement. This rate is sometimes stated in certain leases.

Accounting option for nonpublic entities to use risk-free rate

Rate implicit in lease

Incremental borrowing rate when implicit rate is unknown

Risk-free rate option for nonpublic entities

Reassess only when change lease term
Lease Incentives

• Rent holidays:
  – Reduce lessee ROU asset and lease liability
  – Easier to account for
• Lease incentives are captured as a reduction of the ROU asset upon receipt
• Careful consideration of LHI allowances to determine if it is that of the lessee or lessor

Rent holidays
Payments to, or on behalf of, lessee
Factored into measurement of ROU asset and lease liability
Is it a lease incentive?

**EXAMPLE**

- Engineers, LLC enters into a 5-year lease with Lessor Co. for office space
- Lease payments are $4,000/month
- Lease requires Lessor to reimburse Engineers, LLC for up to $15,000 of improvements made by Engineers, LLC to customize the exterior signage and install an Engineers, LLC logo in the concrete floor of the lobby
- Lease does not require Engineers, LLC to make any improvements
Is it a lease incentive?

EXAMPLE

**Leasehold improvement allowance is a lease incentive**

- Judgment is required when determining if LHIs are lessee vs. lessor assets
- Improvements are determined to be assets of the Engineers, LLC because:
  - Engineers, LLC is not required to make any improvements
  - Improvements are brand specific to the lessee
- $15,000 incentive is treated as a reduction to the total lease payments when payable or when paid. This impacts the measurement of the lease asset and lease liability
Recognition and Measurement
Bring on the Leases

**Recognition & Measurement**

- **ROU asset equals sum of lease liability, prepaid rent and initial direct costs; less lease incentives received.**
- **Lease liability equals present value of lease payments.**
- **Finance leases will result in a front loaded expense vs. straight line for operating leases.**

<table>
<thead>
<tr>
<th>Commencement date</th>
<th>Right-of-use (ROU) asset</th>
<th>Lease liability</th>
<th>Expense patterns</th>
</tr>
</thead>
</table>

2nd Annual CFMA Southwest Regional Conference  |  San Diego, CA
September 25-27, 2016
## Balance Sheet Comparison

**Lease Terms:**
- 3-year lease
- Discount rate = 5.51%
- PV = $300,000

**Payment in arrears of:**
- Year 1: $100,000
- Year 2: $110,000
- Year 3: $125,000

### Finance Lease

<table>
<thead>
<tr>
<th></th>
<th>End of Year 1</th>
<th>End of Year 2</th>
<th>End of Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>R0U asset</td>
<td>$200,000</td>
<td>$100,000</td>
<td>—</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$216,535</td>
<td>$118,470</td>
<td>—</td>
</tr>
</tbody>
</table>

### Operating Lease

<table>
<thead>
<tr>
<th></th>
<th>End of Year 1</th>
<th>End of Year 2</th>
<th>End of Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>R0U asset</td>
<td>$204,868</td>
<td>$105,137</td>
<td>—</td>
</tr>
<tr>
<td>Lease liability</td>
<td>$216,535</td>
<td>$118,470</td>
<td>—</td>
</tr>
</tbody>
</table>
# Expense and Cash Flows Comparison

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Finance Lease</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>$16,535</td>
<td>$11,935</td>
<td>$6,530</td>
<td>$35,000</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total expense</td>
<td>$116,535</td>
<td>$111,935</td>
<td>$106,530</td>
<td>$335,000</td>
</tr>
<tr>
<td>Operating cash flows</td>
<td>$16,535</td>
<td>$11,935</td>
<td>$6,540</td>
<td>$35,000</td>
</tr>
<tr>
<td>Financing cash flows</td>
<td>$83,465</td>
<td>$98,065</td>
<td>$118,470</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total cash flows</td>
<td>$100,000</td>
<td>$110,000</td>
<td>$125,000</td>
<td>$335,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating Lease</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>“Interest component”</td>
<td>$16,535</td>
<td>$11,935</td>
<td>$6,530</td>
<td>$35,000</td>
</tr>
<tr>
<td>“Amortization component”</td>
<td>$95,132</td>
<td>$99,732</td>
<td>$105,137</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total single lease expense</td>
<td>$111,667</td>
<td>$111,667</td>
<td>$111,667</td>
<td>$335,000</td>
</tr>
<tr>
<td>Operating cash flows</td>
<td>$100,000</td>
<td>$110,000</td>
<td>$125,000</td>
<td>$335,000</td>
</tr>
</tbody>
</table>
Presentation and Disclosure
# Financial Statement Presentation

## Operating Lease
- Gross presentation of ROU assets and lease liabilities for operating and finance leases (comingling prohibited)
- Single SL lease expense
- Operating cash flow classification for all payments
- Operating lease liability isn’t debt

## Finance Lease
- Front-loaded interest and SL amortization expense
- Financing and operating cash flow classification
Potential Impacts (Lessee)

Increased liabilities (current and non-current)

- Impact to working capital ratios (e.g. current ratio) and debt ratios

Increased assets

- Lower return on assets

Earnings

- Finance lease – reduced earnings up-front, but larger EBITDA add-back
- Operating lease – no impact
Potential Impacts

How do these changes provide incentives or penalties?

• Will financing leases be more attractive, given all leases are on the balance sheet?

• Will entities be put-off by upfront earnings hit, or will the EBITDA add-back balance this out?

• How will creditors and equity investors view balance sheet metrics and other ratios?

• Will negotiating covenants be more difficult, or will there be a soft transition?
# Footnote Disclosures

## Quantitative
- Periodic lease expense, ROU asset amortization, interest costs
- Short-term, variable leases, sublease income, cash and non-cash flows
- Weighted average discount rate for both finance & operating
- Weighted average remaining lease term for both finance & operating

## Qualitative
- Terms and conditions, purchase options and termination penalties
- Accounting policy elections, areas of significant judgment, assumptions
- Residual value guarantees
- Significant judgments & assumptions
Effective Date and Transition
Effective Dates

<table>
<thead>
<tr>
<th>In fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for:</th>
</tr>
</thead>
<tbody>
<tr>
<td>» Public business entities</td>
</tr>
<tr>
<td>» Not-for-profit entities that have issued (or are a conduit bond obligor for) securities traded, listed, or quoted on an exchange or an over-the-counter market</td>
</tr>
<tr>
<td>» An employee benefit plan that files financial statements with the SEC</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>In fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020, for:</th>
</tr>
</thead>
<tbody>
<tr>
<td>» All other entities</td>
</tr>
</tbody>
</table>

Early adoption permitted
Effective Dates

**Public**

**DATE OF INITIAL APPLICATION**

- January 1, 2017
- December 31, 2017

**EFFECTIVE DATE**

- December 31, 2018
- December 31, 2019

Retrospectively restate these two years.

**Non-Public**

**APPLICATION**

- January 1, 2019

**DATE**

- December 31, 2019
- December 31, 2020

Retrospectively restate
Modified Retrospective Transition

Early adoption using a modified retrospective method for leases entered into or existing as of earliest comparative periods presented (date of initial application). No consideration of leases expiring prior to date of initial application.

Initial ROU asset and lease liability generally equal the carrying amounts of existing capital lease assets and liabilities under ASC Topic 840.
How Will the Change Impact An Organization?

• Policy elections to be made

• Current capabilities and system resources may not be sufficient to identify and capture all leases to apply new standard, if not, consider the need to identify or expand on current lease accounting systems and related internal controls

• Internal and external financial reporting metrics may need to be revised to account for changes in balance sheet and income statement classification

• Accounting for book-tax differences going forward
Where to start . . .

• Identify project leader and availability of resources within your organization to manage the transition process

• Evaluate whether controls and processes are properly designed and implemented across all functional areas (IT, legal, procurement, treasury, accounting)

• Consider benefits of lease accounting software solutions to manage lease accounting and reporting vs. traditional spreadsheets

• Begin process now to review contracts to ensure all leases have been identified and properly accounted for

• Communicate expectations both internally and to key external stakeholders
Additional details and examples: