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Implementing FASB's Updated Lease Accounting Standard

ASU 2016-02 (Topic 842)

Presented by: Gelman, Rosenberg & Freedman CPAs

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Webinar Objectives

Learning Objective *To understand the updated FASB's lease accounting standard, ASU 2016-02 (Topic 842)*	Instructional Delivery Methods *Group Internet-based*
Recommended CPE *1.0 CPE Credit*	Recommended Fields of Study *Audit*
Prerequisites *None required*	Advance Preparation *None*
Program Level *Basic*	Course Registration Requirements *None*
Refund Policy *No fee is required to participate in this session.*	Cancellation Policy *In the event that the presentation is cancelled or rescheduled, participants will be contacted immediately with details.*

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Implementing FASB's Updated Lease Accounting Standard ASU 2016-02

(Topic 842)

March 6, 2019

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CERTIFIED PUBLIC ACCOUNTANTS

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Our Team

Meet Your Instructors

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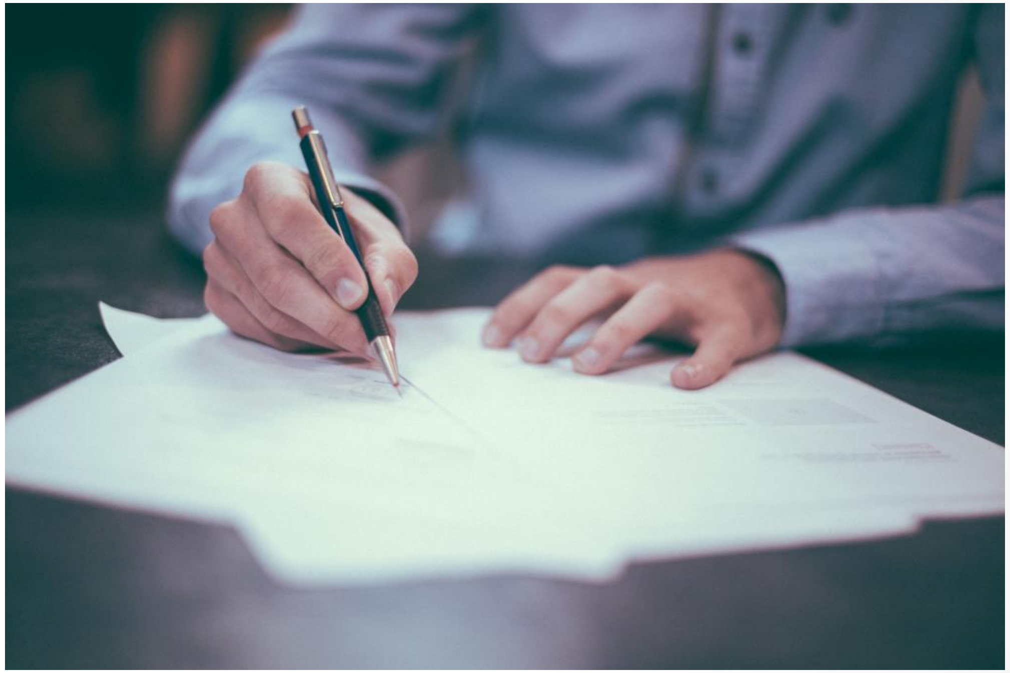
Nonprofit Audit Senior Manager

Why Was The New Standard Implemented?

Objectives

- Increase transparency and comparability
- Disclose key information regarding leasing information on the Statement of Financial Position
- Disclose key information about leasing arrangements
- Improve financial reporting



ASU 2016-02 Topic 842 Leases

Effective Dates

Public Business Entities

(Includes a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market and an employee benefit plan that files financial statements with the US SEC)

- Fiscal years beginning after December 15, 2018
- Calendar year end FS ending December 31, 2019

Non-Public Entities (Not-For-Profits)

- Fiscal years beginning after December 15, 2019
- Calendar year end FS ending December 31, 2020

Early Adoption permitted for all entities*

Definition of a Lease

Per Topic 842

Lease: Is 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.

CONTROL

The right to obtain substantially all the economic benefits from the use of the assets.

The right to direct the use of the assets.

Who is Affected by ASU 2016-02

ASU 2016-02 Topic 842 Supersedes Topic 840 Leases

Any Entity that enters into a lease that meets the definition of a lease, with some scope exemptions.

- Scope Exemptions:
  - Leases of intangible assets (ex: air use rights)
  - Leases to explore for or use minerals, oils, natural gas and similar nonregenerative resources
  - Leases of biological assets
  - Leases of inventory
  - Leases of assets under construction

ASU 2016-02 Topic 842

Core Principle

- Recognition of lease assets and lease liabilities by the lessee
    - Right- of- use asset
    - Lease liability
- If reasonably certain to exercise options within the lease:
    - Should include payments in optional periods
    - Should include optional payments to purchase the asset
- Note- Reasonably certain- a high threshold that is consistent with and intended to be applied
- Should exclude most variable lease payments
- Can exclude leases with a term of 12 months or less, set policy

Lease Classification

Under ASC 842

Assess lease based on the following factors:

1. Transfer of ownership
2. Option to purchase is reasonably certain
3. Term is majority of remaining economic life
4. Present value of lease payments and residual value equal or exceeds substantially all of the fair value of the asset
5. Specialized asset with no use to lessor after term

If you have any of the factors = Finance lease

OR

If none are included = Operating lease

Poll Question #1

Has anyone started the process of identifying the leases that are impacted by the ASU?

A) Yes
B) No

Lessee Classification Example 1

Lessee NP enters into a lease with the following terms:

Lessee NP enters into a lease for non-specialized office equipment with Lessor Corp.	
Lease term	5 years, no renewal option
Economic Life of the equipment	6 years
Purchase option	None
Annual lease payments	$1,100
Payment date	Annually on January 1
Lessee NP's incremental borrowing rate	7% (The rate Lessor Corp charges Lessee NP in the lease is not readily determinable by Lessee NP
Other	Title remains with Lessor Corp upon expiration; the FV of the equipment is $5K and Lessee NP does not guarantee the residual value at the End of lease; no initial direct cost incurred by lessee NP; and no lease incentives by lessor

How Should Lessee NP Classify the Lease

Analysis

Criteria:	Analysis:
1. Transfer of ownership	Ownership of asset does not transfer to Lessee NP by the end of the lease term.
2. Purchase option which the lessee is reasonably certain to exercise	The lease does not contain a lease purchase option.
3. Lease term is for the major part of the remaining economic life of the asset	The Lessee NP is utilizing the asset for approx. 83% of the economic life (5 year life lease/6 year economic life)
4. Sum of the PV of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The PV of the lease payments (discounted at Lessee NP's incremental borrowing rate 7%) is $4,825. Therefore, the PV of the lease payments amounts to approx. 97% of the fair value of the leased asset ($4,825/$5,000) which is substantially all of the fair value of the leased asset
5. Specialized nature	Equipment is not specialized and could be used by another party.

How Should the Lease be Classified???

Lessee NP should classify lease as *Finance Lease*

The lease term is for the major part of the economic life of the equipment and the PV of the lease payments amounts to substantially all of the FV of the underlying asset

Lessee Classification Example 2

Lessee NP enters into a lease with the following terms

Lessee NP enters into a office space lease via a sub lease from NP Lessor:	
Lease term	10 years, with a 5 year renewal option (if exercised, the annual lease payments are reset to then current market rents)
Economic Life of the office space	40 years
Purchase option	None
Fair value of the leased property	$5,000,000
Payment date	Annually on January 1
Lessee NP's incremental borrowing rate	9.04%
Other	Title remains with Lessor Corp upon expiration; Lessee NP does not guarantee the residual value of the real estate at the end of lease; Lessee NP pays for all maintenance, taxes and insurance on property separate from the lease; and there are no initial direct costs incurred by Lessee NP

How Should Lessee NP Classify the Lease

Analysis

Criteria:	Analysis:
1. Transfer of ownership	Ownership of asset does not transfer to Lessee NP by the end of the lease term.
2. Purchase option which the lessee is reasonably certain to exercise	The lease does not contain a lease purchase option.
3. Lease term is for the major part of the remaining economic life of the asset	The lease term is 10 years. The 5 year renewal options available are not reasonably certain of exercise (at lease commencement) because the rate is to be reset based on market rates when exercised. Therefore the Lessee NP is utilizing the asset for 25% of the economic life (10 Year life/ 40 year life) which is deemed not to be a major part.
4. Sum of the PV of lease payments and any residual value guarantee by the lessee amounts to substantially all of the fair value of the underlying asset	The PV of the lease payments using the lessee's 9.04% rate is $1,262,490 (500K initial payment with an escalation of 3% per year less the $200K lease incentive in the second year)and the FV of the property is $5M, represents only 25% of the value
5. Specialized nature	Property is in a specific location; however, it could be used by another party without major modification.

How Should the Lease be Classified???

Lessee NP should classify lease as *Operating Lease*

None of the criteria in ASC 842-10-25-2 and ASC 842-10-25-3 have been met

ASU 2016-02 Topic 842

Finance & Operating Leases

Finance Lease

Statement of Financial Position:

- Right-of-use asset
- Lease Liability

Statement of Activities:

- Interest expense
- Amortization expense of the right-of-use asset

Cash Flows:

- Repayments of principal payments within finance activities
- Payments of interest on the lease liability within operating activates

Operating Lease

Statement of Financial Position:

- Right-of-use asset
- Lease Liability

Statement of Activities:

- Single lease costs, calculated so the cost of the lease is allocated over the lease term on straight-line basis

Cash Flows:

- All cash payments within operating activities

Lease Versus Non-Lease Components

Under Topic 842 & Practical Expedient

- Components include only those that transfer a good or service to the lessee
  - Executory cost are considered part of the lease such as real-estate taxes, insurances, etc. if included into the fixed payments to the lessor
  - Right to use land is considered to be a separate lease component unless the accounting effect would be immaterial

Examples of Non-lease Components:

- Providing common area maintenance of lease office space
- Providing a receptionist for a sublease tenant
- Payments directly to taxing authority and/or insurance provider are generally variable lease payments

PRACTICAL EXPEDIENT-Non-Lease Components

- A lessee may elect an accounting policy, by asset class, to include both the lease and non-lease components as a single component and account for it as a lease
- This expedient is not available for Lessors

Modified Retrospective Transition

- Adopt to all leases that have not yet expired at initial application date
- Measure at the beginning of the earliest period presented
- Optional practical expedients
- Specific transition guidance for leveraged leases, sale and leaseback transactions, and build to suit

ASU 2018-11 PRACTICAL EXPEDIENT:

- Provides an additional option for transition-
  - Apply at the adoption date
  - Recognize a cumulative-effect adjustment to the opening balance of net assets
  - Comparative periods continue to report under current GAAP Topic 840, including disclosures under Topic 840
- May opt to apply the original modified retrospective transition in Topic 842, including practical expedients- apply at the beginning of the earliest period presented, even if those leases expired prior to the effective date

Modified Retrospective Transition

(continued)

- Incorrect assessments under ASC 840 are not grandfathered into ASC 842
- If a lease was classified as an operating lease under ASC 840, and will continue as an operating lease under ASC 842:
  1. The lessee should recognize a right-of-use-asset and lease liability at the later date of
     - Earliest period presented, or
     - The lease commencement date
  2. Unamortized initial direct costs remaining at the later date of a) the earliest period presented, or b) the lease commencement date that would not have qualified for capitalization under the new lease standard should be written off with an offsetting entry to net assets
  3. After initial recognition, a lessee should measure the lease liability and the right-of use asset in accordance with the subsequent standard

Operating Leases

Transition Adjustments

1. The lease liability should be calculated as the PV of the sum of the following:
   - The remaining minimum rental payments (defined by ASC 840)
   - Any amounts probable of being owed by the lessee under a residual value guarantee
2. The discount rate used to calculate the PV should be determined at the later of
   - The earliest period presented, or
   - The commencement date

Operating Leases

Transition Adjustments (continued)

3. The operating lease right-of-use asset should be measured at an amount equal to the lease liability, adjusted for the following:
   - Prepaid or accrued rent
   - Remaining balance of any lease incentives
   - Unamortized initial direct costs that would have qualified for capitalization under the lease standard
   - Any impairment
   - The carrying amount of any liability related to the lease recognized in accordance with ASC 840, exit or disposal cost obligations

Discount Rate to Apply

- Lessor should apply the rate implicit in the lease
- Lessees should apply the implicit rate, or the lessee's incremental borrowing rate if the implicit rate cannot be readily determinable
- Nonpublic entity exception- permitted to use a risk-free discount rate determined using a period comparable to that of the lease term as an accounting policy election for all leases

Example of Operating Lease With Practical Expedients Elected

Facts:

- Effective date of transition is January 1, 2020 for the NP
- Lease commenced on January 1, 2018
- Lease term is 5 years
- Annual rent: $31,000 in year 1 and year 2 and $33,000 for years 3-5 (A total of $161,000)
- Initial direct costs were $500
- Incremental borrowing rate 6%
- Carrying amount at January 1, 2019 was deferred rent of $1,200 and unamortized initial direct costs of $400

Example of Operating Lease With Practical Expedients Elected (*continued*)

Initial Entry:

- Lease Liability at 1/1/2019 = $31,000 + ($33,000 x 3 years) at 6 % = $112,462
- ROU asset at 1/1/2019 = $112,462 + 400 - $1,200 = $111,662
  - (Lease liability + unamortized initial direct costs – unamortized deferred rent)
- Deferred rent at 1/1/2019 = $1,200
- Unamortized initial direct costs at 1/1/2019 = $400
- Journal entry:

Dr. ROU asset	$ 111,662	
Dr. Deferred rent	$ 1,200	
Cr. Lease liability		$112,462
Cr. Other asset		$ 400

Annual Payment:

- Annual Lease expense at inception = $161,000 + $500 = $161,500 / 5 years = $32,300
  - (Annual rent for the entire lease $31k for 2 years + $33K for 3 years + total initial direct costs paid)
- Journal Entry:

Dr. Lease expense	$32,300	
Dr. Lease Liability	$24,764	
Cr. ROU asset		$ 26,064
(lease expense- interest at 6% $6,236)		
Cr. Cash		$ 31,000

Capital Leases

Transition Adjustments

1. Capital leases that are continuing as finance leases after transition should do the following:
   - Reclassify capital lease asset as right-of-use asset, and capital lease obligation as lease liabilities, for each period the lease was outstanding, beginning with the earliest period presented
   - Any unamortized initial direct cost that meet the definition of initial direct costs under the new lease standard should be added to the right-of-use asset established at transition
     - Note- costs that do not qualify for capitalization under the new leases standard should be written off with an offsetting entry to net assets
   - For comparative periods presented before the effective date, measure the right-to-use assets and liability in accordance with the subsequent measurement guidance in ASC 840

Poll Question #2

Does anyone plan to early implement the lease standard?

A) *Yes*
B) *No*

Lease Incentives

General Principles

1. Lease incentives can be any payment made by the landlord to, or on behalf of, a tenant to fund items that would be an expense or obligation of the tenant
   - Includes reimbursement for moving expenses or assumption of the lessee’s preexisting lease
   - Allowance may be a fixed amount or may be a certain amount per square foot
2. When a lessor pays a tenant for improvements, the payments are either going to be:
   - Reductions of lease expense/lease income if deemed a lease incentive
   - Lessor is inquiring tangible assets- lessor capitalizes the cost as PP&E and depreciates it over the life of the asset

Lease Incentives

General Principles (continued)

3. In determining lease liability at lease commencement, only the remaining lease payments are PV to establish the lease liability. Generally improvements are made prior to lease commencement and would not need to be deducted against remaining lease payments:
   - Operating leases – lease incentives are deducted against the straight-line lease expenses
   - Finance lease – lease incentives are deducted against the ROU Asset, so the straight line amortization expense is lowered

Lease Incentives

Scenarios

1. Lessee receives a tenant improvement allowance as an incentive to sign the lease. (The allowance may be based on fixed amount or amount per square foot of leased space.) The lessor controls the allowance and pays the construction directly for the improvements. The lessee is not entitled to any allowance money not spent by the lessor. Lessor owns the assets:
   - No entry required by the lessee
   - Lessor would capitalize the cost and depreciate over the life of the asset
2. Lessee makes improvements to a rented space for the purpose of building out the space. Lessor to reimburse lessee. The lessor is deemed to own the improvements.
   - Lessee would record as cost are incurred: Dr. Prepaid rent and Cr. Cash
   - When reimbursed by landlord: Dr. Cash and CR Prepaid rent
   - Note- if not fully reimbursed, the difference would be to Dr. ROU asset and Cr. Prepaid rent

Lease Incentive

Scenarios (continued)

3. Lessor pays Lessee cash incentive at lease execution to enter lease.
   - Lessee at lease execution: Dr. Cash and Cr. Lease incentive payable
   - At lease commencement: Dr. Lease incentive and Cr. ROU asset
   - Finance lease: ROU asset is amortized straight line, which is reduced by the lease incentive
   - Operating lease: Fixed lease payments are reduced by the lease incentive to calculate the straight line expense

Lease Incentive

Scenarios (continued)

4. Lessee makes improvements to a rented space for the purpose of building out the space. Lessee is deemed to own the improvements. Lessor reimburses lessee through an incentive or an allowance.
   - When expenditure incurred by lessee: Dr. LHI and Cr. Cash (Each reporting period you would amortize the LHI via amortization exp)
   - To recognize reimbursement owed from the lessor: Dr. Receivable and Cr. Lease incentive payable (apply the cash received and reduce the receivable upon receiving payment)
   - At lease commencement date: Dr. Lease incentive payable and Cr. ROU asset
   - Operating lease: Reduce fixed lease payments by lease incentive in calculating the expense to SL
   - Finance lease: Since ROU asset was credited for the lease incentive, the SL amortization expense is reduced
   - Cash received from Lessor: Operating cash inflow
   - Cash paid to acquire assets: Investing activity outflow

Lease Incentive

Scenarios (continued)

5. Lessor makes improvements and paying the construction costs directly to the contractor; however, the lessee is deemed to own the improvements.
   - When expenditure incurred by lessor, lessee will : Dr. LHI and Cr. Lease incentive payable
   - At lease commencement: Dr. Lease incentive payable and Cr. ROU asset
   - LHI: Amortize over the useful life of the asset
   - Operating lease: Reduce fixed lease payments by lease incentive, the SL amortization expense is reduced
   - Finance lease: Since ROU asset was credited for the lease incentive, the SL amortization expense is reduced.
   - Non-cash investing disclosure in the statement of cash flow

Disclosures

Qualitative and Quantitative

Qualitative	Quantitative
Nature of the leases	Short term lease costs
Any short term lease exemptions made	Operating lease costs
Leases that have not commenced but are significant	Sublease income
Significant judgments made in applying the standard	Variable lease costs
Main terms of sale-leaseback transactions	Gains/losses from sale/leaseback arrangements
	Finance lease expenses (amortization + interest)
	Lease payment maturity

Disclosures

Separate for Finance and Operating

- Cash paid for amounts in lease liabilities; segregated between operating and financing
- Lease liabilities arising from each type
- Weighted average term
- Weighted average discount rate

Poll Question #3

What do you think will be the greatest hurdle to your organization's implementation of the new standard?

A) *Identifying the leases between operating and financing?*
B) *Calculating the PV of the lease liability*
C) *Recording the lease transaction within the general leger*
D) *Do not know at this time*

LESSOR Accounting

Largely unchanged from previous GAAP

1. Vast majority of operating leases remain operating leases
2. Lessors should recognize lease income on straight-line-basis over the lease term
3. Changes to the lessor accounting guidance:
   - Glossary terms updated
   - Topic 842 retains alignment in key respects between the lessor accounting guidance and revenue 606

To Do List

1. Identify a champion to oversee the implementation of ASU 2016-02 (Topic 842). Senior management should be involved.
2. Review the FASB PDF version of the ASU 2016-02 (Topic 842).
3. Provide training to all staff via in-house trainings, external seminars, webinars, etc.
4. Review systems in place and update internal controls and policies, as necessary.
5. Identify existing leases between finance and operating.
6. Calculate the PV of the lease liability and the right-of-use asset
7. Review disclosures for each lease identified

Questions

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