Leases: Last Call

Meet the Implementation Deadline for the New Lease Accounting Standard

Thursday, December 1, 2022

CPAs & ADVISORS

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Housekeeping

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- Technical questions about the survey can be addressed to Nathan McElveen at nmcelveen@grfcpa.com.

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Additional Information

Learning Objective To provide attendees with a better understanding of the new lease standard and practical solutions for implementation.	**Instructional Delivery Methods** Group Internet-based
Recommended CPE 1.0 CPE Credit	**Recommended Fields of Study** Accounting
Prerequisites None required	**Advance Preparation** None
Program Level Basic	**Course Registration Requirements** None
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Today's Presenters

accountingTODAY
2022 Firms to Watch

accountingTODAY
2022 Regional Leaders

INSIDE PUBLIC ACCOUNTING TOP 200 FIRMS 2022

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What we will cover today

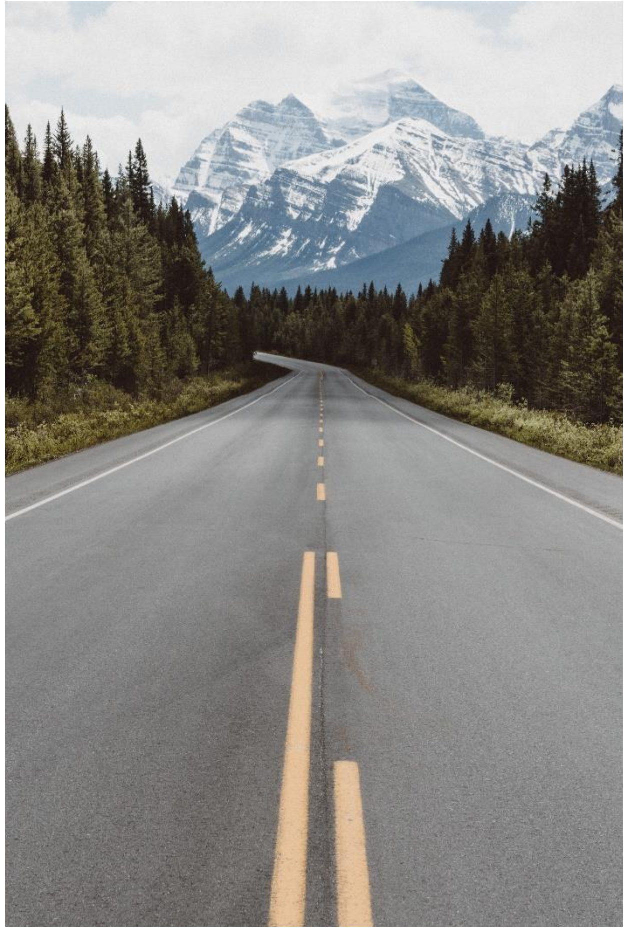
- Summary of changes in lease accounting as a result of ASU 2016-02 (Topic 842) for both lessors and lessees.
- Implementation of the new standard and common issues faced.
- Changes in disclosures
- Expedited implementation tips

ASU 2016-02 (Topic 842)- Why?

- According to FASB, this new standard was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements.
- Heavier impact on lessees. Lessor accounting was not fundamentally changed with this update.
- Main difference between previous GAAP and Topic 842: Recognition of lease assets and liabilities on the balance sheet(statement of financial position) by lessees for those leases classified as operating leases under previous GAAP.

ASU 2016-02 (Topic 842)- Who?

- FASB ASC 842 is applicable to any entity that enters into a lease and applies to all leases and subleases of property, plant, and equipment.
- It does **NOT** apply to the following nondepreciable assets accounted for under other FASB ASC topics:
    - Leases of intangible assets
    - Leases to explore for or use nonregenerative resources such as minerals, oil, and natural gas
    - Leases of biological assets, such as timber
    - Leases of inventory
    - Leases of assets under construction



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Effective Date of Implementation

- **Public entities** (including nonprofits and employee benefit plans that qualify as public entities)
    - Effective for year beginning after 12/15/2018
    - Public entity nonprofits may extend another year due to COVID
- **All other entities**
    - Effective for year beginning after 12/15/2019
    - Due to COVID, pushed to effective date for year beginning after 12/15/2020.
    - Pushed again another year due to COVID 19- Fiscal years beginning 1/1/2022
- Early implementation is permitted.

Implementation Method

- ASC Topic 842 requires a modified retrospective transition, with the cumulative effect of transition as of either:
    - The effective date
    - The beginning of the earliest comparative period presented.
- As an accounting policy, a lessee may elect not to apply the recognition requirements to short-term leases and instead, may recognize the lease payments in profit or less on a straight-line basis over the lease term and variable lease payments in the period in which the obligation for those payments is incurred.

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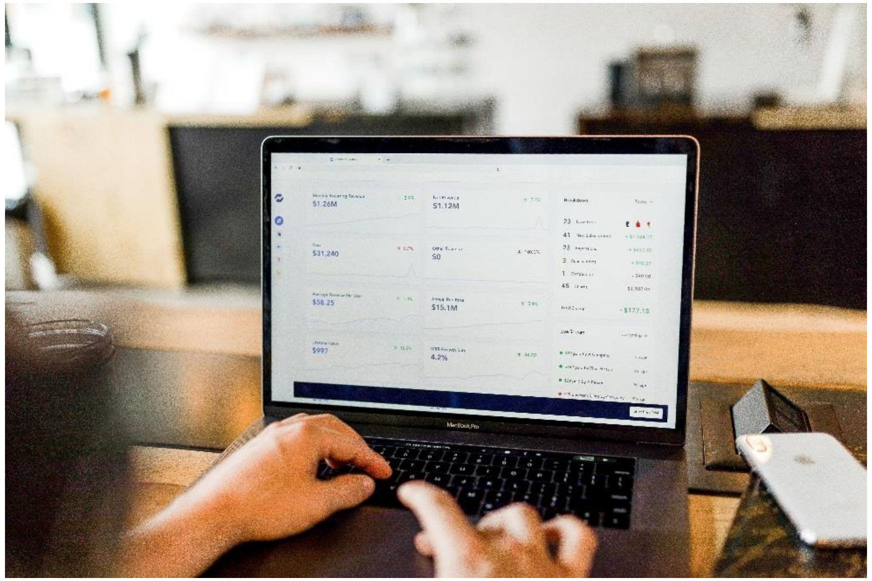
Practical Expedients



- Identification and classification of leases that commenced before the effective date
- Reevaluation of existing lease classifications
- Initial direct costs for leases that commenced before the effective date
- Ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset and impairment.

Polling Question #1

Have you identified the leases that are impacted by the new lease standard?

A. *Yes*
B. *No*
C. *Unsure*

Lease Identification/Classification

- **What is a Lease**
- **Finance lease**
  - Lease transfers ownership by end of lease term
  - Lease grants a purchase option that lessee is reasonably certain to exercise
  - Lease term is for a major part of the remaining economic life of the underlying asset.
  - PV of sum of lease payments and any guaranteed residual value by the lessee equals or exceeds substantially all of the FV of the underlying asset.
  - Specialized asset has no alternative use to the lessor the end of the lease term.
  - Finance lease for lessee; sales-type lease for lessor
- **Operating lease** – if none of the above criteria applies.
  - Operating lease for lessee; direct financing lease for lessor

Components of a Lease

- Account for lease components separately
- Distinct lease component if:
  - Lessee can benefit from the right of use, either on its own, or together, with other resources AND
  - The right of use is neither highly dependent on nor highly related with the other rights to use the assets
- Is the component a lease, or is it a non-lease component?

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
- This expedient will increase the total lease liability

Allocating Consideration to Lease Components

1. Determine the standalone price of the separate components based on observable standalone prices.
   - If not available, lessee should estimate the standalone price using a method that maximizes the use of observable information.
   - Residual estimation approach if the standalone price for a component is highly variable or uncertain.
2. Allocate the consideration in the contract on a relative standalone price basis to the separate components of the contract.
3. Allocate any initial direct costs to the separate lease components on the same basis as lease payments.

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

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Operating Leases

Transition Adjustments

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

Transition Adjustments

- 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
- Non Public 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***
- ***Accounting Standards Update No. 2021-09, Leases (Topic 842): Discount Rates for Lessees That Are Not Public Business Entities permit a risk-free rate election by class of underlying assets, rather than at the entity wide level.

Other considerations

- Account for a lease modification as a separate contract when both are present:
  - Modification grants the lessee an additional right of use not included in the original lease
  - Lease payments increase commensurate with the standalone price for the additional right of use.
- If modification is not accounted for as a separate contract, Company should reassess the classification of the lease as of the effective date of the modification.
- Commencement date
- Refundable security deposits
- Initial direct costs
- Variable payments

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Polling Question #2

If you have prepared a lease calculation, what discount rate did you determine was appropriate?

A. Rate implicit in the lease

B. Incremental borrowing rate

C. Risk-free rate

D. Unsure

Presentation and Disclosure

Lessees- Presentation

Balance Sheet/Statement of Financial Position

- Finance lease right-of-use assets and operating lease right-of-use assets separately from each other and from other assets
- Finance lease liabilities and operating lease liabilities separately from each other and from other liabilities.
- Current / noncurrent classification
- Either present or disclose!
- Cannot combine finance lease and operating lease right-of-use assets, and finance lease and operating lease liabilities- keep them separate.

Example

Company X

Schedule of Items Appearing on the Balance Sheet

12/31/Year 1

Property, Plant, and Equipment		
Finance Lease Right-of-use Asset	$	263,238
Less: Accumulated Depreciation - Finance Lease Right-of-Use Asset		176,648
Finance Lease Right-of-Use Asset (net)		241,591
Opearing Lease Right-of_use Asset		173,596
Current Liabilities		
Finance Lease Liability		175,569
Operating Lease Liability		164,071
Long-Term Liabilities		
Finance Lease Liability		223,082
Operating Lease Liability		164,526

Lessees- Presentation, continued

Statement of Comprehensive Income/Statement of Activities

- For finance leases: interest expense on the liability and amortization of the right-of-use assets are not required to be presented as separate line items
- For operating leases: lease expense shall be included in the lessee's income from continuing operations.

Statement of Cash Flows

- Repayments of principal portion of the lease liability arising from finance leases within financing activities
- Payments arising from operating leases within operating activities
- Variable lease payments and short-term lease payments not included in the lease liability within operating activities.

Example

Company X
Schedule of Items Appearing on the Income Statement
12/31/Year 1

Operating Expense:	
Interest expense	$ 15,241
Depreciation expense	65,851
Lease expense	30,000

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Example

Company X
Schedule of Items Appearing on the Statement of Cash Flows
12/31/Year 1

Direct Method	
Operating Activities	
Cash collections from revenues	$ X,XXX,XXX
Cash payments for expenses	
Cash paid for interest	15,241
Cash paid for operating lease expense	(30,000)
Indirect Method	
Operating Activities	
Net Income	
Adjustments to Reconcile Net Income to Net Cash Provided by operations:	
Depreciation expense	65,851
Financing Activities	
Reduction of finance lease liability	(19,588)

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Lease Classification

Finance Lease

Balance Sheet/Statement of Financial Position:

- Right-of-use asset, initially measured at PV
- Lease Liability

Income Statement/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 activities

Operating Lease

Balance Sheet/Statement of Financial Position:

- Right-of-use asset, initially measured at PV
- Lease Liability

Income Statement/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

Lessees- Disclosures

Objective – To enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.

Disclosures- both quantitative and qualitative

- General information about its leases
- Basis and terms and conditions on which variable lease payments are determined.
- Existence and terms and conditions of options to extend or terminate.
- Existence and terms and conditions of residual value guarantees provided by the lessee.
- Any restrictions or covenants imposed by leases.
- Information about leases that have not yet commenced
- Information about significant assumptions and judgments made in applying this Topic
- Any practical expedients applied

Lessees- Disclosures

For each period presented in the financial statements, lessee shall disclose the following amounts:

- Finance lease cost
- Operating lease cost
- Short term lease cost
- Variable lease cost
- Sublease income
- Net gain or loss recognized from sale and leaseback transactions
- Amounts segregated between those for finance and operating leases for the following items:
  - Cash paid for amounts included in the measurement of lease liabilities, segregated between operating and financing cash flows
  - Supplemental noncash information on lease liabilities arising from obtaining right-of-use assets
  - Weighted-average remaining lease term.
  - Weighted-average discount rate.

Example

	12/31/20XX	
Lease Cost	$	XX
Finance Lease Cost		XX
Amortization of right-of-use assets		XX
Interest on lease liabilities		XX
Operating lease cost		XX
Short-term lease cost		XX
Variable lease cost		XX
Sublease income		(XX)
Total lease cost	$	XX

Example

Year ending December 31	20X9	20X8
(in thousands)		
Operating:		
Operating leases, included in program services expenses	$ 694	$ 618
Short-term leases, included in program services expenses	87	77
Variable lease payments, included in program services expenses	49	44
Finance:		
Amortization of assets, included in depreciation and amortization	107	46
Interest, included in interest expense	76	29
Sublease income, included in other income, net	(46)	0
Net lease cost	$ 967	$ 814
Cash flow information:		
Cash paid for amounts included in measurement of lease liabilities:		
Operating cash flows from operating leases	$ 667	$ 507
Operating cash flows from finance leases	76	29
Financing cash flows from finance leases	63	20
Lease assets obtained in exchange for lease liabilities:		
Operating leases	688	555
Finance leases	846	777
Lease Term and Discount Rate:		
(in years)		
Weighted average remaining lease term—Operating leases	6	6
Weighted average remaining lease term—Financing leases	12	11
Weighted average discount rate—Operating leases	2.3%	2.1%
Weighted average discount rate—Financing leases	4.5%	4.1%

Polling Question #3

What do you think will be the biggest challenge in implementing the new standard for your organization?

A. *Determining if the lease is an operating or finance lease*
B. *Determining the discount rate*
C. *Determining the journal entries to record the lease transactions*
D. *Unsure*

Lessees- Disclosures

A lessee shall disclose a maturity analysis of its finance lease liabilities and its operating lease liabilities separately, showing the undiscounted cash flows on an annual basis for a minimum of each of the first five years and a total of the amounts for the remaining years. A lessee shall disclose a reconciliation of the undiscounted cash flows to the finance lease liabilities and operating lease liabilities recognized in the statement of financial position.

Example

Maturities of lease liabilities were as follows:

(In millions)

Year Ending June 30,	**Operating Leases**	**Finance Leases**
2018 (excluding the six months ended December 31, 2017)	$ 750	$ 167
2019	1,413	340
2020	1,287	347
2021	1,025	353
2022	839	360
Thereafter	2,634	3,857
Total lease payments	7,948	5,424
Less imputed interest	(965)	(1,522)
Total	$ 6,983	$ 3,902

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Lessors- Disclosures

Objective – To enable users of the financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases.

Disclosures- both quantitative and qualitative

- General information about its leases
- Basis and terms and conditions on which variable lease payments are determined.
- Existence and terms and conditions of options to extend or terminate.
- Existence and terms and conditions of options for a lessee to purchase the underlying assets
- Information about significant assumptions and judgments made in applying this Topic
- Lease income recognized in each annual (or interim) reporting period
- Information about how it manages its risk associated with the residual value of its leased assets.
- Specific disclosures for sales-type leases and direct financing leases
- Maturity analysis of its lease receivables, showing the undiscounted cash flows to be received on an annual basis for a minimum of each of the first 5 years and a total of the amounts for the remaining years.

Other Presentation and Disclosure Considerations

- Impairment of Right-of-Use Asset
- Leases Denominated in a Foreign Currency
  - Right of Use Assets will use different conversion rates based on the commencement of the lease denominated in foreign currency
  - Lease liability will use the current spot rate for each reporting period
  - Gains and Losses from Foreign Currency Conversion
- Sales and Leaseback Transaction
  - Review and apply Accounting Standards Codification 606 (ASC 606) (e.g. existence of a contract, performance obligations, transaction price
  - Gains and losses arising from sales leaseback transactions are reported separately from gains or losses from other assets.

Examples


GULF OF MEXICO
Chicago
Detroit
Milwaukee
Cleveland
New Orleans
St. Louis
Habana
Jamaica
Kingston
HONDURAS
NICARAGUA
CARIBBEAN SEA
Tropic of Cancer

Operating Lease Example

- Lessee enters into a 10 year lease for 10,000 square feet of office space in a building with a remaining economic life of 50 years.
- Annual payments= $100,000, paid in arrears
- Lessee's incremental borrowing rate at the commencement date is 6%.
- Modification – At beginning of year 6, modified so that the total lease term increases from 10 to 15 years. The annual lease payments are increased to $110k per year for the remaining 10 years after the modification.
    - Lessee's incremental borrowing rate at date of modification= 7%.

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Operating Lease Example continued

- At date of modification:
  - Reassess classification of the lease
  - Remeasure the lease liability on the basis of the 10 year remaining lease term, 10 remaining payments of $110k, and its incremental borrowing rate at the effective date of the modification.

Operating Lease Example continued

Reassessed of amounts already paid:

Rate	6%
NPer	5
Pmt	100,000
FV	0
Type	0
	$421,236.38

Reassess of new lease terms:

Rate	7%
NPer	10
Pmt	110,000
FV	0
Type	0
	$772,593.97

Increase in liability of $351,357.59- recorded as an adjustment to the right-of-use assets (no income/ loss effect from modification

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Finance Lease

- Lessee enters into a 5- year lease of equipment with annual lease payments of $59,000, payable at the end of each year.
- At end of year 5- option to purchase the equipment for $5k.
- At end of lease, expected residual value is $75k.
- Fair value of equipment at commencement date is $250k, economic life is 7 years.
- Discount rate for the lease is not available, thus, use Lessee's incremental borrowing rate of 6.5%.
- Lessee plans on exercising the option.

Finance Lease - continued

Present value of 5 payments of $59k:

(PV formula in excel)

Rate	6.5%
NPer	5
Pmt	59,000
FV	0
Type	0
	$245,185.09

Present value of the $5k purchase option:

(NPV formula in excel)

Rate	6.5%
Value 1	0
Value 2	0
Value 3	0
Value 4	0
Value 5	5,000
	$3,649.40

Total liability recorded= $248,834.49

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Finance Lease - continued

- Lessee amortizes the right-of-use asset over the 7 year expected useful life of the equipment, rather than 5 years
- During first year of lease:
  - Record interest expense on the lease liability of $16,174
    - 6.5% x $248,834
  - Amortize of the right-use-of asset of $35,548
    - $248,834 / 7
- At the end of year 1,
  - Right of use asset = $213,286 ($248,834 - $35,548)
  - Lease liability= $206,008 ($248,834 + $16,174 int expense - $59,000)

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Finance Lease - continued

- At end of year 5
  - Carrying amount of the right-of-use asset is $71,094 ($248,834 – [35,548 x 5])
  - Remaining lease liability is $5k, which lessee exercises the purchase option and settles the remaining lease liability.
  - Reclass the remaining right-of-use asset to property, plant, and equipment.

Other considerations- LHI

- Lessee or lessor asset
    - Indicators:
        - What happens when the lease ends?
        - Specialized
        - Who supervises and bears the cost of the build out?
        - Who is the legal owner?
- If a lessee asset, leasehold improvements with a tenant improvement allowance- treated as a lease incentive that reduces the ROU asset.
    - If allowance is not yet received, lease liability is also reduced in future minimum lease payments.

ASC 840	ASC 842
Reported as a separate liability. Liability would have been reduced on a straight-line basis and reduced rent expense.	If paid up front, reduces the tenant's ROU asset, but adds a LHI asset in the amount that was paid.

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Implementation

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Tips for a Successful Implementation

1. Include a task force of internal and external finance professionals capable of assessing the impact of ASC Topic 842 (include your auditors!)

2. Assess your leases, determine your population, determine type of lease

3. Select when- either effective date, or the beginning of the earliest comparative period presented.

4. For each lease, focus on (document/confirm):

    1. Lease term- consider extension, renewal, early-termination clauses
    2. Account for purchase options
    3. Identify lease payments
    4. Account for variable lease payments
    5. Determine the discount rate to use to calculate the present value of operating or finance lease payments
    6. Account for a lease arrangement's initial direct costs

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Tips for a Successful Implementation

5. Evaluate and record – document methodologies, record related journal entries.
6. Carefully assess the appropriate financial statement presentation and disclosure
7. Post-implementation:
    - Develop updated accounting policies, including the creation of new general ledger accounts for more streamlined financial reporting and disclosure preparation
    - Update any necessary internal controls

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Questions?

Contact Us

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