INDIANA NFP WORKSHOP

The New Lease Standard

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ASU 2016-02

- ASU 2016-02, *Leases*
  - Creates Topic 842, *Leases*, in the FASB Codification
  - Supersedes FASB ASC 840, *Leases*
  - Applies only to leasing of property, plant, and equipment
  - Entities that hold numerous equipment and real estate leases, in particular those with numerous operating leases, will be most affected by this new guidance

Highlights

- Operating leases will now be recorded in the statement of financial position as assets and liabilities
- Retains a distinction between finance leases and operating leases

Highlights

- No more “bright-line” thresholds as under current
- U.S. GAAP
  - 75% life
  - 90% fair value
  - Bargain purchase option
  - Title transferred at the end of the lease term
  - FASB ASC 842-10-66-2 notes that numerical thresholds above are “one reasonable approach” to assessing lease classification criteria

Poll Question 1:

Have you analyzed the impact to your financial statements of implementing the new leasing standard (FASB ASC 842)?

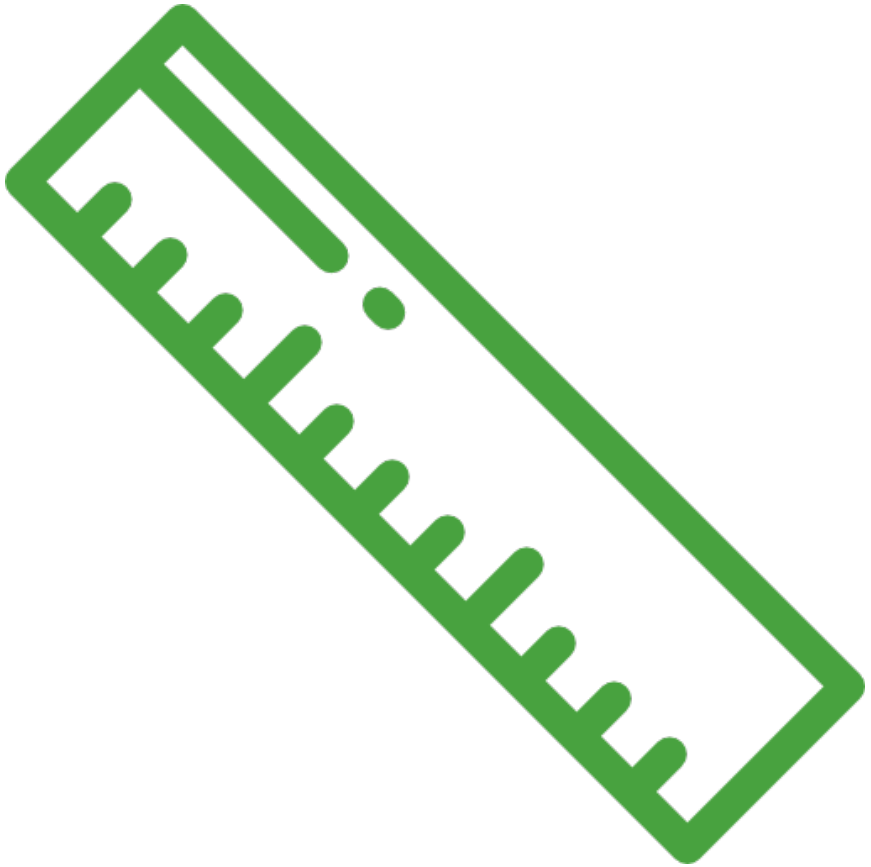
- Yes
- No

ASU 2020-05: Deferral of Lease Standard

- The effective date of FASB ASC 842 is deferred by one year, as follows:
  - For private companies and private NFPs, to fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022
    - Calendar Year End 2022
  - For public NFPs that have not yet issued their financial statements (or made financial statements available for issuance) reflecting the adoption of FASB ASC 842, to fiscal years beginning after December 15, 2019, including interim periods within those fiscal years
    - Calendar Year End 2020

Short-Term Lease Exception

- For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election not to recognize lease assets and lease liabilities
- If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term
- Election needs to be consistently applied for similar leases



Think about it

Entity enters into an auto lease for 12 months with an option to extend for an additional 12 months.

- Entity is unsure at inception if they will exercise the option
- Entity elects accounting policy of not recognizing right-of-use assets & liabilities arising from short-term obligations

Is the auto lease considered a short term lease?

Poll Question #2

- Is this 12-month lease with option to extend for 12 more months still qualify as a short-term lease if uncertain if exercising option?
  - Yes
  - No
  - Unsure

Lease Term Debrief

- Lessee considers all relevant factors
- – Determines that it is not reasonably certain to exercise the option to extend
- Because at lease commencement lessee is not reasonably certain to exercise the option to extend, the lease term is 12 months
- The lease meets the definition of a short-term lease
- Lessee does not recognize the right-of-use asset and the lease liability

Short-Term Lease Exception

- Significant economic disincentives to both parties for entering into a series of short- term leases in place of longer-term leases
  - Not a significant structuring risk throughout the system
  - Lessees may have to pay a premium rental price to compensate the lessor for its increased residual asset risk
  - Some lessors will be unable to enter into short-term leases depending on the terms of the financing they obtained to acquire the underlying asset

Why not structure all leases as short-term leases?

Lessees– **Operating Leases**

FASB ASC 842: Leases

Operating Leases

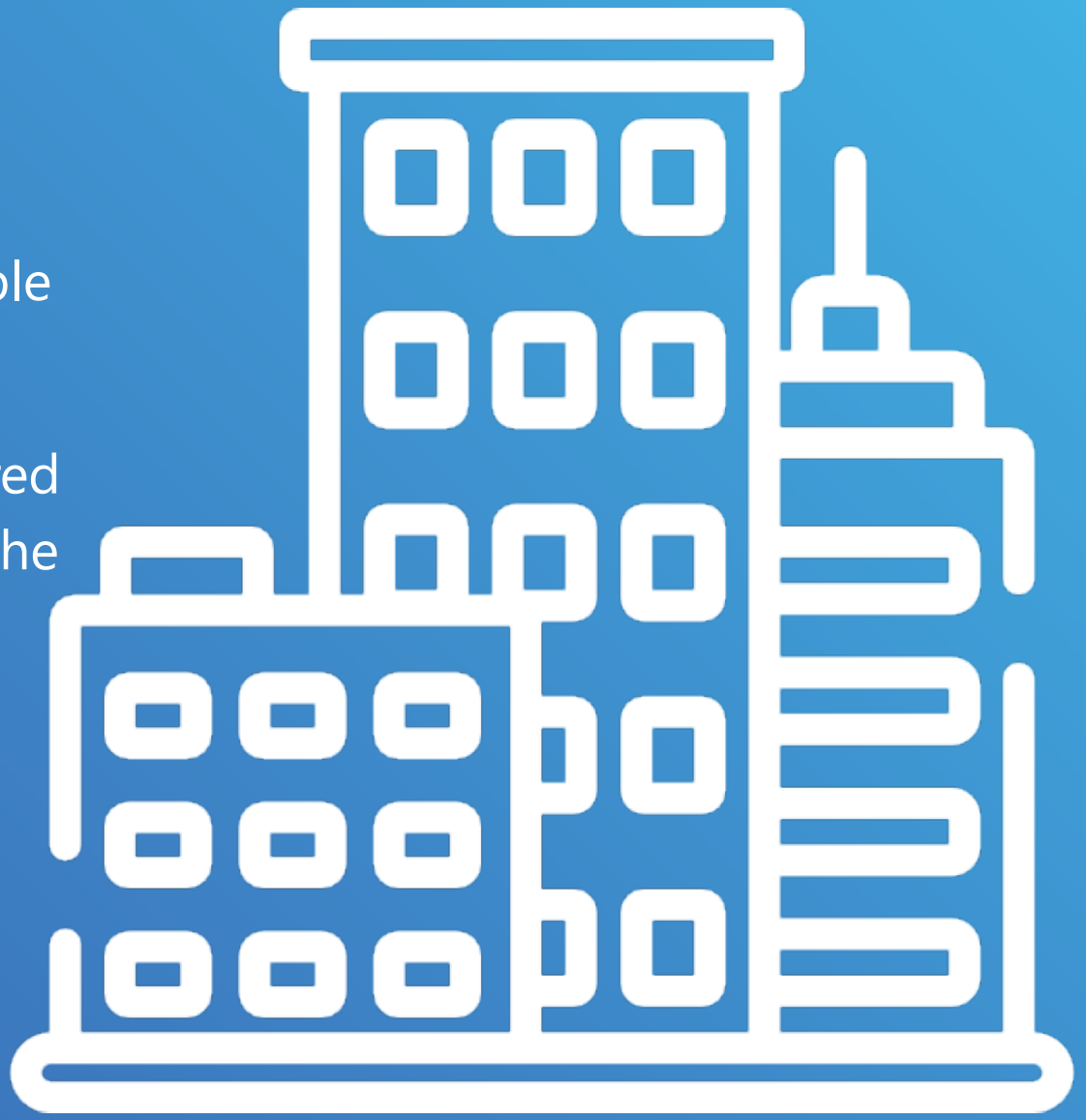
- Lessee accounting for operating leases:
  - Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position
  - Recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term on a generally straight-line basis
  - Classify all cash payments within operating activities in the SOCF

Operating Leases

- Variable lease payments (which are not in substance fixed payments) that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date
  - Not updated unless a remeasurement event takes place
  - To the extent more payments are shifted to variable lease payments, absent a remeasurement event, balance sheet right-of-use asset and lease liability would decrease
  - – Shifting in lease arrangements as a result??

Think about it

- Lessee enters into a 10-year lease of a building with annual lease payments of $100,000, payable at the beginning of each year
- The contract specifies that Lessee also is required to make variable lease payments each year of the lease, which are determined as 2 percent of Lessee's sales generated from the building



Is the variable consideration included in the lease liability calculation?

Variable Lease Payments Debrief

- At the commencement date, Lessee measures the lease liability and right-of-use asset and does not include the variable payments in the measurement of the lease liability (or the right-of-use asset) at any point during the lease
- During the first year of the lease, Lessee generates sales of $1.2 million from the building
- Therefore, Lessee recognizes total lease cost of $124,000 ($100,000 + [2% × $1.2 million])
- Lessee will include $100,000 of the $124,000 in its disclosure of operating lease cost and $24,000 in its disclosure of variable lease cost
  - – Some entities have noted the additional compliance costs involved in tracking the new disclosure of variable lease cost

Operating Lease Example

- Payments of $10,000 annually for five years
- Interest rate at 5%

Year	Lease Liability	Cash Paid	Interest Accretion	Right of Use Asset	Amortization of Right of Use Asset (PLUG)	Straight Line Lease Expense
			A		B	A+B
0	$43,295			$43,295		
1	$35,460	$10,000	$2,165	$35,460	$7,835	$10,000
2	$27,232	$10,000	$1,772	$27,232	$8,228	$10,000
3	$18,594	$10,000	$1,362	$18,594	$8,638	$10,000
4	$9,524	$10,000	$930	$9,524	$9,070	$10,000
5	$0	$10,000	$476	$0	$9,524	$10,000
Total		$50,000	$6,705		$43,295	$50,000

Operating Lease Example

Year	Lease Liability c a	Cash Paid	Interest Accretion	Right of Use Asset	Amortization of Right of Use Asset (PLUG)	Straight Line Lease Expense
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1	$35,460	$10,000	$2,165	$35,460	$7,835	$10,000

Top Side Journal Entry at Year 1:

Lease Right of Use Asset	$ 10,000	
Lease Liability		$ 10,000

Previously recorded cash payment through normal bookkeeping for Year 1:

Lease Expense	$ 10,000	
Cash		$ 10,000

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Lessees– **Finance Leases**

FASB ASC 842: Leases

Finance Leases

- A lessee is required to classify a lease as a finance lease when it meets any one of the following criteria: (GREEN= NEW)
  - Ownership of the underlying asset transfers to lessee by the end of the lease term
  - The lease grants lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
  - The lease term is the major part of the remaining economic life of the underlying asset
  - The present value of the sum of the lease payments and any residual value guarantees by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset
  - The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term

Finance Leases

- Lessee accounting for finance leases:
  - Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the statement of financial position
  - Recognize interest on the lease liability separately from amortization of the right- of-use asset in the statement of comprehensive income
  - Classify repayments of the principal portion of the lease liability within financing activities and payments of interest on the lease liability and variable lease payments within operating activities in the statement of cash flows

Finance Leases

- Some key differences from the previous standard:
  - No “bright lines” incorporated into the criteria (however, 75 percent of useful life and 90 percent minimum lease payment thresholds are “one reasonable approach” per FASB ASC 842-10-55-2)
  - The guidance no longer uses the term “bargain purchase option”
  - There are now five capital lease criteria instead of four with the addition of “specialized nature that is expected to have no alternative use to the lessor” criterion

Lessee Accounting Overview

	Balance Sheet	Income Statement	Cash Flow Statement
Finance	• Right-of-use (ROU) asset • Lease liability	• Amortization expense • Interest expense	• Principal- financing Interest- operating
Operating	• Right-of-use (ROU) asset • Lease liability	• Single lease expense on a straight-line basis	• Lease expense- usually operating

- Balance sheet presentation- can not present finance leases/operating leases on same line and must break out each on face or in notes
- Balance sheet classification- Financial liabilities (current portion)/nonfinancial assets
- Income statement presentation- Single lease expense presented in income from continuing operations

Discount Rate

- The rate that the entity uses to discount future lease payments should be the rate implicit in the lease if it is readily determinable
- If not determinable, the entity should use its incremental borrowing rate

Discount Rate- Incremental Borrowing Rate

- The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment

Incremental Borrowing Rate definition has been subtly changed, which may more significantly impact discounted values

- A lessee may use a single discount rate to apply to a portfolio of leases assuming the result would not be significantly different than individual discount rates

Private entities are permitted an accounting policy election to use a risk-free discount rate for the lease (normally the federal funds rate)

Renewal Options

- Include payments to be made in optional periods only if the lessee is reasonably certain to exercise an option to extend the lease or not to exercise an option to terminate the lease
- Optional payments to purchase the underlying asset should be included in the measurement of lease assets only if the lessee is reasonably certain to exercise that purchase option

Lease Term

- The lease term should be the sum of the non-cancellable period of the lease along with any periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option as well as any options to extend that would be controlled by a lessor

Non-Cancellable Lease Period

Periods Reasonably Certain to Extend

Options to Extend Controlled by Lessor

Poll Question #3

- How many leases do you have?
  - Less than five
  - More than five, less than 20
  - More than 20
  - Unsure

Segregating Lease/Non-Lease Components

- Many contracts contain both lease and non-lease components
- ASU 2016-02 provides expanded guidance on how entities should account for contracts with lease and non-lease components
  - Subject to reallocation by lessee (only) upon a remeasurement of lease liability and contract modification not accounted for as a separate contract (lessee and lessor). Subsequent variable payments not reallocated.
- Will have significant financial reporting consequence since operating leases are now capitalized while services are not
- There is a practical expedient that allows lessees and lessors to account for the non- lease components together with the related lease components as a single lease component (lessors must meet additional criteria)
  - Policy election by class of underlying asset which most adopters elected

Definition of a Lease

- What is a lease?
  - Understanding the definition and determining whether a contract is or contains a lease will be crucial
  - Much more extensive than previous U.S. GAAP

Legacy U.S. GAAP	FASB ASC 842
• An agreement conveying the right to use property, plant, or equipment (land and/or depreciable assets) usually for a stated period of time	• 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

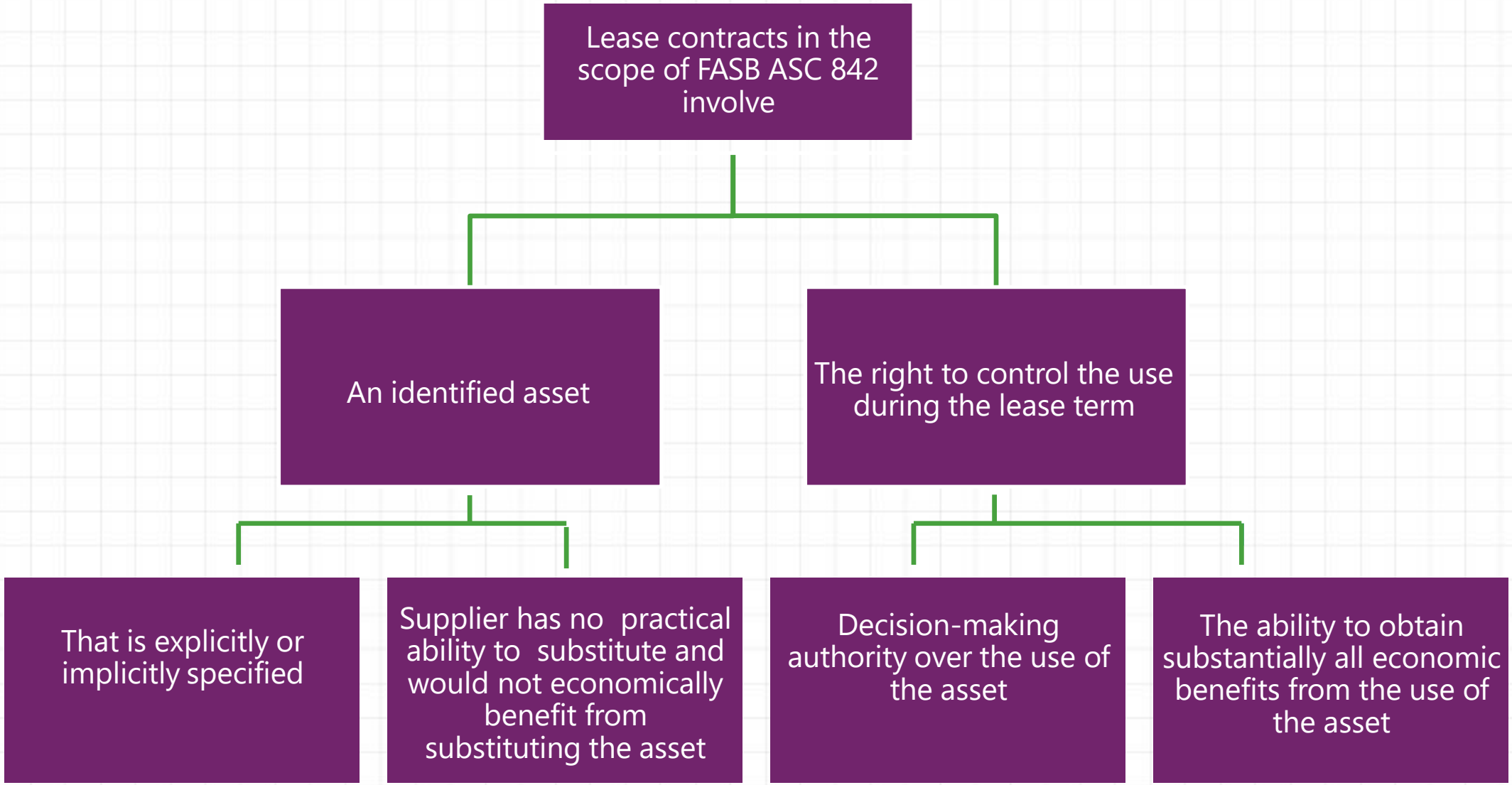
Definition of a Lease

- Key differences in the 2 definitions:
  - New definition refers specifically to a contract and includes mention that a lease can be viewed as only being part of a contract
  - New definition specifically includes the term “control” within the context of the lease
  - New definition includes mention of the fact that the lease requires an “exchange of consideration”
- This definition was changed from the original ED issued in 2010 (which retained the original definition currently in U.S. GAAP), as respondents noted that the 2010 definition would result in a significant increase in the number of contracts considered to be a lease

Does a Contract Contain a Lease?

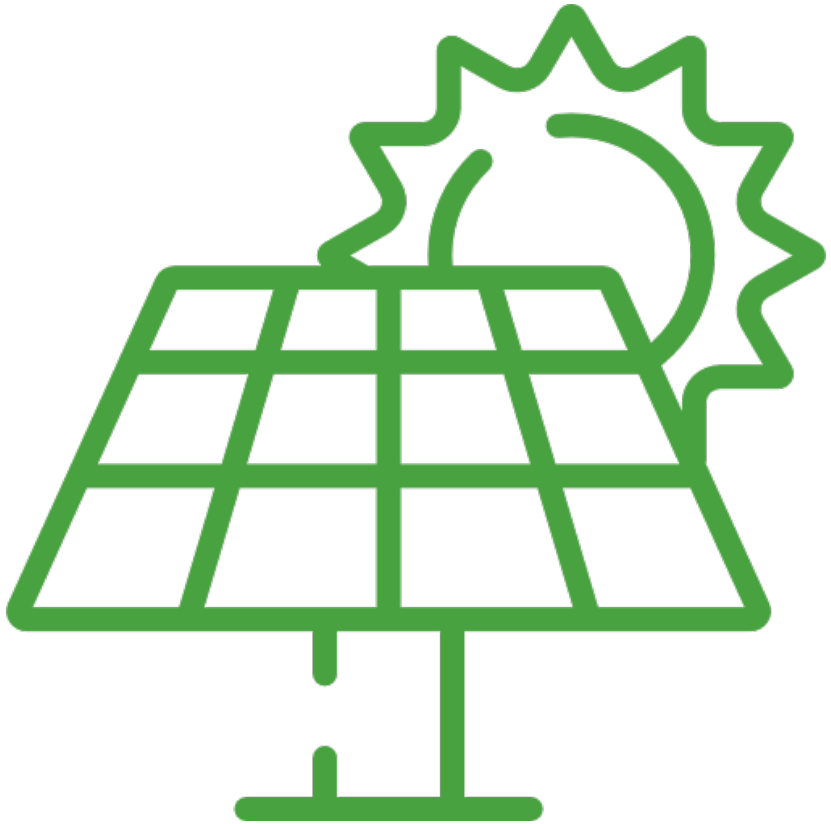
- The FASB noted the following in respect to the determination of whether a contract contains a lease:
  - In most cases, the assessment of whether a contract contains a lease should be straightforward
    - The intention is that a contract will either fail to meet the definition of a lease by failing to meet many of the requirements or will clearly meet the requirements to be a lease without requiring a significant amount of judgment
  - The FASB did add more guidance in the final ASU to make it easier for entities to make the lease assessment for more complicated scenarios
  - There is a helpful flowchart in the implementation guidance section of FASB ASC 842

Identifying a Lease



Embedded Leases

- Can be either made explicitly or implicitly
  - Concept of an “embedded lease”
  - Need to look for implicitly identified assets
- Example 9
  - Case A, contract from specified solar farm
  - Meets criteria therefore contains a lease
  - Case C, contract from specified power plan
  - Meets criteria therefore contains a lease
- Manufacturing supply contracts, oil/gas supply contracts, airline feeder contracts



Challenges with Embedded Leases

- May not have been identified in prior service arrangements
- Likely do not use the words “lease” or “rent”
- Lessees may not fully understand nature of equipment used to fulfill contract, especially when highly technical
- Significant Judgment Required
  - Determine if substation rights are substantive
  - Determine if lessee controls the asset- specifically does lessee have decision making rights??

Common Sources of Embedded Leases

- Outsourced manufacturing arrangements which provide exclusive use of space or equipment in facility
- Agreements that bundle a service and a device
- Sale of consumables with “free” equipment
- Data Center or outsourced IT arrangements which provide exclusive use of assets
- High dollar construction equipment (i.e. cranes)

Lease vs. Service Contract- High Level

Lease Characteristics	Service Contract Characteristics
• Lessor fulfills obligation by transferring right to use an asset at commencement date	• Supplier fulfills obligation by performing during the contract period • Performance to date does not benefit customer throughout remainder of service period
• Lessee continues to benefit throughout term as a result of lessor making the asset available at commencement	• Benefit obtained only as supplier performs services
• Lessee cannot avoid making lease payments without breaching contract once right to use asset has been transferred	• Customer typically only obligated to pay for the services as they are provided

Characteristics in table based on BC40- BC42 of ASU 2016-02

Effective Date and Transition

- Modified retrospective approach, where entities will essentially run off those leases existing at the beginning of the earliest comparative period presented
- For operating leases, a lessee will present a lease liability in the statement of financial position at each reporting date equal to the present value of the remaining minimum rental payments and a right-of-use asset that is derived from the lease liability
- Recently issued amendments allow another transition method

Effective Date and Transition

- Recently Issued Amendments to Lease Standard
  - Add an option for transition to FASB ASC 842, that would permit an organization to apply the transition provisions of the new standard at its adoption date instead of at the earliest comparative period presented in its financial statements
  - This additional transition method would change <u>when</u> an entity would be required to initially apply the transition requirements of the new lease standard; it would not change <u>how</u> those requirements apply

Effective Date and Transition

- Recently Issued Amendments to Lease Standard
  - Allows entities to initially apply the requirements by recognizing a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption
  - Consequently, an entity's reporting for the comparative periods presented in the financial statements in which the entity adopts the new lease requirements would continue to be in accordance with current FASB ASC 840, including disclosures

Effective Date and Transition

- Practical expedients:
  - First practical expedient, which must be elected as a package and consistently applied to all leases, notes that an entity need not reassess each of the following--
    - Whether any expired or existing contracts are or contain leases
    - The lease classification for any expired or existing leases
    - Initial direct costs for any existing leases
  - Second practical expedient notes that an entity may use hindsight in determining the lease term and in assessing impairment of an entity's right-of-use assets
    - Must be applied consistently to all leases

Questions?

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