New Lease Accounting Standards: Are you ready?

May 23, 2019
Introductions

Jennifer Wold, CPA
Partner | Wichita office
jwold@bkd.com

Megan Adams, CPA
Director | Wichita office
madams@bkd.com
Today’s Agenda

1. Background on ASU 2016-02 (Topic 842)
2. Core Principle & New Rules
3. Implications
4. Next Steps
Question 1

How extensive is your background on the new standard?

- Excellent – I’m ready to implement!
- Good – I’m almost there but could use some more guidance
- Fair – I know the general concepts but not ready to implement
- Poor – what new standard?
Background on ASU 2016-02 (Topic 842)
Background on ASU 2016-02

- Lease guidance has had limited changes since FASB 13 issued in **November 1976**
- Decade-long joint project between FASB & IASB
- Issued February 2016
- Codified into ASC 842 (superseding ASC 840)
- Lessor accounting remained relatively unchanged
FASB’s Reason for New Standard

- Increase comparability & transparency among entities
- Significantly reduce off-balance-sheet risk
- More reflective of true substance of leasing transactions
Additional Perspectives

“… more faithful representation of an organization’s leasing activities …”

SEC – largest form of off-balance-sheet financing

2005 SEC estimate – $1.25 trillion off-balance-sheet operating lease commitments for SEC registrants

Amount increases when you consider all entities impacted (public & nonpublic)
Core Principle & New Rules
A lessee should recognize the assets & liabilities that arise from right-of-use (ROU) assets. All leases create an asset & a liability for the lessee in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*. 

Core Principle – Right-of-Use Model
Effective Dates – ASC 842

Public Entities
Annual & interim reporting periods beginning after December 15, 2018

All Others
Annual reporting periods beginning after December 15, 2019

Adoption date is January 1, 2019, for public entities with a December 31 year-end

Public entities (PEs) include conduit debt obligors
Applies to interim periods in fiscal year of adoption for PEs
GASB has different (but similar) changes
## Transition – Public Entities (12/31 Year-End)

<table>
<thead>
<tr>
<th>Transition Timing – January 1, 2019, Adoption</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2018</td>
</tr>
<tr>
<td>FY 2019</td>
</tr>
<tr>
<td>ASU 2016-02 As issued</td>
</tr>
<tr>
<td>ASC 842</td>
</tr>
<tr>
<td>Cumulative catch-up at beginning of the first year presented (1/1/18)</td>
</tr>
<tr>
<td>ASC 842</td>
</tr>
<tr>
<td>ASU 2018-11 Optional transition relief</td>
</tr>
<tr>
<td>ASC 840</td>
</tr>
<tr>
<td>ASC 842</td>
</tr>
<tr>
<td>Cumulative catch-up at beginning of the year of adoption (1/1/19)</td>
</tr>
</tbody>
</table>
### Transition – Private Entities (12/31 Year-End)

**Transition Timing – January 1, 2020**

<table>
<thead>
<tr>
<th></th>
<th>FY 2019</th>
<th>FY 2020</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASU 2016-02</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>As issued</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>ASC 842</strong></td>
<td><strong>ASC 842</strong></td>
</tr>
<tr>
<td>Cumulative catch-up at</td>
<td></td>
<td></td>
</tr>
<tr>
<td>beginning of the first</td>
<td></td>
<td></td>
</tr>
<tr>
<td>year presented (1/1/19)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>ASU 2018-11</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Optional transition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>relief</td>
<td><strong>ASC 840</strong></td>
<td><strong>ASC 842</strong></td>
</tr>
<tr>
<td>Cumulative catch-up at</td>
<td></td>
<td></td>
</tr>
<tr>
<td>beginning of the year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>of adoption (1/1/20)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Determining Whether a Lease Exists

Identified Asset
- Explicitly or implicitly specified
- Not able to substitute

Right to Control
- Decision-making authority
- Substantially all the economic benefits
An Identified Asset

A leased asset must be specifically identifiable as either

- Explicitly, *e.g.*, by a serial number
- Implicitly, *e.g.*, only asset that would satisfy the lease contract
  - Supplier does not have practical ability to substitute alternative asset, *e.g.*, customer can prevent substitution
  - Supplier would not benefit from substituting alternative asset

A physically distinct portion of a larger asset could represent a specified asset, *e.g.*, one floor of a building. A capacity portion of a larger asset generally is not a specified asset, *e.g.*, percentage of a storage tank.
Right to Control the Use of the Asset

A lease contract conveys the right to control the use of the identified asset for a specified period of time. A customer controls an identified asset when the customer has both of the following:

1. **Right to direct its use**
   - The right to direct how & for what purpose the asset is used, including the right to change how & for what purpose the asset is used.

2. **Right to obtain substantially all economic benefits from its use**
   - By having exclusive use of the asset throughout the period.
Short-Term Leases

Leases, at commencement date, have a term of <12 months & do not include option to purchase underlying asset that the lessee is reasonably certain to exercise.

This policy election must be disclosed in the financial statements.

**Warning:** the existence of lease extensions & the likelihood of extending the arrangement must be considered in determining the term.

Entities can make a formal policy election to not recognize short-term leases on the balance sheet.
**Related-Party Leases**

<table>
<thead>
<tr>
<th>Old Guidance – ASC 840</th>
<th>New Guidance – ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>Used substance over form in evaluating the existence of a lease</td>
<td>Use the legally enforceable terms &amp; conditions of the agreement</td>
</tr>
</tbody>
</table>

In the separate financial statements of the related parties, the classification & accounting for the leases should be the same as for leases between unrelated parties.
## Contracts with Multiple Components

<table>
<thead>
<tr>
<th>Lease Component</th>
<th>Nonlease Component</th>
<th>Not a Separate Component</th>
</tr>
</thead>
</table>
| • A separate right-of-use for an asset  
  • Lessee can benefit from the right-of-use of the underlying asset either on its own or together with other readily available resources. The use is neither highly dependent on nor interrelated with other assets  
  • Payments accounted for as a separate lease | • An activity that transfers a separate good or service to the customer, *e.g.*, supplies/disposables  
  • **Includes maintenance services**  
  • Allocated payments are nonlease period expense | • Related to administrative tasks to initiate the lease & payment of lessor costs that do not transfer a separate good or service separate from the ROU asset  
  • **Includes payments for insurance or property taxes**  
  • Payments are part of lease payment, not separately allocated |
Question 2

Classifying leases between operating & financing is not relevant under the new standard

- True
- False
Lease Classification

How to determine the accounting for your lease?

1. Lease will be classified as finance lease if it transfers substantially all risks & rewards of ownership (meets one of the five criteria on the next page).

2. Bright-line tests are not required; can be used as a reasonable approach/policy.

3. All other leases will be classified as operating leases.
Ownership of asset transfers to lessee by end of lease term

Lessee has purchase option that it is reasonably certain to be exercised

Lease term is for major part of economic life of asset (n/a for leases that commence “at or near the end” of the underlying asset’s economic life, e.g., in the final 25 percent of an asset’s economic life)

PV of minimum lease payments amounts to at least substantially all of fair value of leased asset

NEW: 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
**Lessee Accounting – Initial Measurement**

<table>
<thead>
<tr>
<th><strong>Lease liability (obligation to make lease payments)</strong></th>
<th>• Measured at the present value of the future lease payments*</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Right-of-use (ROU) asset</strong></td>
<td>• Lease liability + initial direct cost + lease prepayments − lease incentives received</td>
</tr>
</tbody>
</table>

*Lease liability is computed the same regardless of whether the lease is classified as an operating lease or a finance lease*
Discount Rate

Lessee uses

› Rate charged by the lessor if the rate is readily determinable
› Otherwise, incremental borrowing rate

• Private companies can elect to use a risk-free rate – need to follow consistently & need to weigh benefits & costs
Lessee Model – Subsequent Accounting

Annual expense recognition & subsequent amortization of ROU asset depends on lease classification

› Finance lease
  • Unwind liability using the effective interest method
  • Front-loaded expense pattern similar to today’s capital leases with interest & amortization recognized separately
  • Interest determined on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate
  • ROU asset generally amortized on a straight-line basis
Lessee Model – Subsequent Accounting

› Operating lease
  • Unwind liability using the effective interest method
  • Straight-line expense over term
  • ROU asset: reduced by the difference between the annual straight-line lease expense & the annual interest cost on the lease liability, *i.e.*, amortize the asset to achieve straight-line total lease expense
    › The expense is essentially a “plug”
## Comparison of Lessee Accounting Models

### Finance Lease
- **Balance sheet**
  - Right-of-use (ROU) asset
  - Lease liability

- **Income statement**
  - Interest expense (on lease liability)
  - Amortization expense (on ROU asset)

- **Cash flow**
  - Cash paid for principal payments (financing activities)
  - Cash paid for interest payments & for variable lease payments (operating activities)

### Operating Lease
- **Balance sheet**
  - Right-of-use (ROU) asset
  - Lease liability

- **Income statement**
  - Lease/rent expense (straight-line)

- **Cash flow**
  - Cash paid for lease payments (generally operating)
Question 3

Does your organization have arrangements where you are provided a piece of equipment at no charge?

• Yes
• No
• Not sure
Simplified Lease Example Details

- Six-year lease
- No renewal options
- Lease payments $40,000 paid EOY
- Includes 9% interest rate

In this simplified example, the lease liability & the right-of-use asset are both $179,437 (present value of six payments of $40,000 each, at a discount rate of 9%)

The journal entry (regardless of financing vs. operating) would be:
Dr. Right-of-use asset $179,437
Cr. Lease liability $179,437
In this simplified example, if the arrangement is determined to be a *financing lease*, the lessee recognizes both amortization expense & interest expense, with higher expense in the initial years.
In this simplified example, if the arrangement is determined to be a **operating lease**, there is only rent expense & the expense is straight-lined.

The total expense for the lease is the same whether it is a financing arrangement or an operating arrangement – equals total cash paid.
## Further Complexities

### Additional Common Terms

- Renewal term options
- Lease incentives
- Direct costs incurred
- Prepaid rent
- Escalating/variable payments
- Lease modification
- Multiple components
- Inception date different than commencement date
- Subleases
- Other
Lease with Renewal Options

› The lease term is defined as the **noncancellable period** for which a lessee has the right to use an underlying asset, plus any optional periods that are **reasonably certain** that the lessee will exercise the renewal option, not exercise a termination option or options that are controlled by the lessor.

• **Reasonably certain** is a high threshold that uses judgement
Lease Renewal Options Example

• 10 year lease for new office space with 2 five year options
• Annual lease payments of $100,000 for initial lease term and $150,000 for option years
• Lease liability equals the present value of the lease payments for all renewal periods that are reasonably assured
• ROU asset equals the lease liability + initial direct costs + lease prepayments – lease incentives received
Escalating Rent Payments and Lease Incentive Example

- 10 year lease for new office space
- Annual lease payments of $100,000 for years 1-5 and $150,000 for years 6-10
- Lease incentive $50,000 and initial direct costs incurred of $5,000
- Lease liability equals the present value of the lease payments
- ROU asset equals the lease liability + initial direct costs + lease prepayments – lease incentives received
Lease Modifications

› There are two types of lease modifications

1. Modification accounted for as a separate contract
2. Standard lease modification
Lease Modification – Separate Contract

Account for the modification as a separate contract when both of the following are true:

1. Modification grants the lessee an additional right of use, i.e. additional sq ft
2. Lease payments increase inline with the standalone price of the additional right of use

Write-off the old ROU asset and lease liability and capitalize the new ROU asset and lease liability
Lease Modification - Standard

A change to the terms and conditions of a lease contract that results in a change to the scope or consideration of a lease.

- Changing the lease term – extending the lease for a renewal period not reasonably assured at the lease commencement date
- Changing the lease consideration – negotiated a rent reduction
Accounting for a Standard Lease Modification

1. Reassess the lease classification as of the effective date of the modification
2. Remeasure the lease liability using the discount rate on the effective date of the modification
3. Recognize the change to the lease liability as an adjustment to the right-of-use asset
When to Reassess the Lease Term

Lease term reassessment is required when:

- The lessee controls a significant change in circumstances that affects the previous conclusion of whether an option to extend or terminate a lease is reasonably certain.
- There is an event written into the contract requiring the lessee to exercise (or not exercise) an option to extend or terminate the lease.
- Lessee elects to exercise an option that was previously not reasonably assured.
- Lessee elects to \textit{not} exercise an option that was previously reasonably assured.
The below table shows acceptable and unacceptable ways to present these balances on the lessee's balance sheet (note that for simplicity this is an unclassified balance sheet).

<table>
<thead>
<tr>
<th>Separate Presentation</th>
<th>Presentation with Other Assets and Liabilities and Disclosed Separately</th>
<th>Combined Presentation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Acceptable</strong></td>
<td><strong>Not Acceptable</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Balance Sheet</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Period Ended December 31, 20X1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROU assets – operating lease</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td>ROU assets – finance lease</td>
<td>900</td>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>1,100</td>
<td></td>
</tr>
<tr>
<td>Operating lease liabilities</td>
<td>25,150</td>
<td>25,150</td>
</tr>
<tr>
<td>Finance lease liabilities</td>
<td>850</td>
<td>Other liabilities</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>1,000</td>
<td></td>
</tr>
</tbody>
</table>

**Disclosure**

For the period ended December 31, 20X1, right-of-use assets from finance leases of $900 are included as part of property, plant and equipment.

For the period ended December 31, 20X1, lease liabilities from finance leases of $850 are included as part of other liabilities.
Disclosure Objective

Enable users of financial statements to assess amount, timing & uncertainty of cash flows arising from leases

› Policies & nature of leases
› Significant assumptions
› Quantitative disclosure examples
  • Financing lease costs, operating lease costs, short-term lease costs & variable-lease costs
  • Weighted average remaining lease term, weighted average discount rate & supplemental noncash transaction information
  • More info: sublease income, sale-leaseback gains & others
Implications
Implications

- Bond or loan covenants (definitions of lease or debt)
- Financial statement ratios
- Borrowing capacity
- Rating agency impacts
- Implementation time & resources
- Polices, processes, controls, systems & people
## Impacts: Covenant Compliance

<table>
<thead>
<tr>
<th>Arrangements</th>
<th>Analysis</th>
<th>Conclusions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory all arrangements with compliance/covenant calculations</td>
<td>Analyze terms &amp; alignment with old vs. new GAAP</td>
<td>Conclude, communicate &amp; confirm</td>
</tr>
</tbody>
</table>

Whether ASU 2016-02 will have an impact on these covenants & ultimately, compliance with them, may depend on how the borrowing documents define “debt” or “indebtedness” including whether such terms are in accordance with existing U.S. GAAP at signing of arrangements or U.S. GAAP in place at each reporting date.
Mitigating the Risk of a Covenant Default

Review financial covenants in borrowing agreements to determine if ASU 2016-02 will affect compliance

Key assessments

- Assess whether borrowing documents allow calculations in accordance with GAAP in effect on date of delivery of document
- Assess if balance sheet based covenants are adversely impacted
- Assess if operating leases are considered “debt” or “indebtedness”
- If risk of default, assess amending borrowing documents

If operating leases are considered debt, every time an operating lease is entered into, additional debt test has to be met.
## Impacts: Accounting & Reporting

### Adoption Project

- Education & communication
- Project team & resource considerations
- Timeline, project management, adoption methods
- Assessment of risk of material misstatement on financial statements
- Centralized vs. decentralized
- Inventory of all lease agreements, service contracts & other arrangements that might contain ROU assets
- Assessment of arrangements & adoption
- Adoption disclosures
# Impacts: Accounting & Reporting

## Ongoing: Policies, Processes & Controls

- Definitions requiring management’s judgment, *e.g.*, definition of lease, lease term, terminology, *e.g.*, “insignificant,” “reasonably certain,” “substantially all” & book vs. tax differences
- Ongoing remeasurement requirements, *e.g.*, index or rate changes, modification to contract terms, lessee’s assessment of options to extend or terminate or purchase underlying asset
- Increased ongoing disclosure requirements
- Update policies, process & controls & related control documentation
Impacts: Information Systems

System requirements

- Separate record-keeping for lease & nonlease components
- Amortizing right-of-use assets
- “Triggering” of reassessment criteria
- Maintain financial reporting & internal control risk at acceptable level
- Data retention & security; audit trails for lease classification & changes
- Support management’s buy vs. lease/sale-leaseback decisions; lease negotiations
- Support management’s financial statement forecasting & budgeting requirements, e.g., anticipated changes in ROA & EBITDA calculations
Question 4

Do you believe the change will require a change in current accounting systems or implementation of new systems?

• Yes
• No
• Not sure
## Level of Complexity: Organizational Considerations

<table>
<thead>
<tr>
<th>Less Complex</th>
<th>More Complex</th>
</tr>
</thead>
<tbody>
<tr>
<td>• One enterprise resource planning system</td>
<td>• Multiple enterprise resource planning systems</td>
</tr>
<tr>
<td>• One centralized accounting &amp; financial reporting team</td>
<td>• Multiple accounting &amp; financial reporting teams, <em>e.g.</em>, JEs processed by different teams)</td>
</tr>
<tr>
<td>• Low turnover/consistent team members in key positions of procurement, facilities, property/PPE accounting &amp; controllership</td>
<td>• High turnover/new members in key positions of procurement, facilities, property/PPE accounting &amp; controllership</td>
</tr>
</tbody>
</table>
Level of Complexity: Lease-Specific Considerations

Less Complex
- Key team members already educated/trained
- Leases & other arrangements all entered into through one centralized group
- Existing & effective lease management software in place
- Lease accounting & disclosures already tied to lease administration software
- Package of practical expedients selected, hindsight not used & cumulative catch-up at date of adoption

More Complex
- Key team members needing education/training
- Leases & other arrangements entered into through multiple avenues throughout the organization
- No lease management software or not an effective system
- Lease accounting & disclosures highly dependent upon spreadsheets
- Practical expedients not selected, hindsight used &/or cumulative catch-up at first date of presentation
## Optional Relief

<table>
<thead>
<tr>
<th>Transition Elections</th>
<th>Accounting Policy Elections</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expedient package – identification, classification, initial direct costs*</td>
<td>Separation of lease &amp; nonlease components for both lessee &amp; lessor</td>
</tr>
<tr>
<td>Hindsight</td>
<td>Portfolio approach</td>
</tr>
<tr>
<td>Land easements</td>
<td>Short-term leases</td>
</tr>
<tr>
<td>Prior-period presentation</td>
<td>Materiality thresholds (capitalization policy)</td>
</tr>
<tr>
<td></td>
<td>Discount rate (non-PBEs only)</td>
</tr>
<tr>
<td></td>
<td>Presentation of taxes</td>
</tr>
</tbody>
</table>

*These three must be elected as a package*
## Level of Complexity: Adoption Method Considerations

<table>
<thead>
<tr>
<th>Less Complex</th>
<th>More Complex</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Package of practical expedients selected</td>
<td>• Practical expedients not selected</td>
</tr>
<tr>
<td>• Hindsight not used</td>
<td>• Hindsight used</td>
</tr>
<tr>
<td>• Cumulative catch-up at date of adoption</td>
<td>• Cumulative catch-up at first date of presentation</td>
</tr>
</tbody>
</table>
What to Do Now?

1. Read the standard & related resources; identify a champion or task force to study the new standard

2. Review bond covenants & other arrangements; draw preliminary conclusions relative to how accounting change will be viewed in relation to the terms

3. Determine if resource bandwidth & competencies exist within the organization or if outside assistance is needed

4. Educate audit committees, boards & other stakeholders
What to Do Now?

5. Engage facilities, procurement, IT & finance staff (& third party, if deemed necessary)

6. Identify right-of-use asset arrangements & inventory the arrangements

7. Analyze arrangements for accounting changes & document

8. Adopt & develop disclosures
Questions?
Thank You!

The information contained in these slides is presented by professionals for your information only & is not to be considered as legal advice. Applying specific information to your situation requires careful consideration of facts & circumstances. Consult your BKD advisor or legal counsel before acting on any matters covered.