ASC 842: Leasing Standards

July 29, 2019

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Grant Thornton LLP
Agenda

1. Overview of the New Leasing Standard
2. Definition of a Lease
3. Components of a Contract
4. Lessee Accounting with Example
5. Disclosures, Transition, and Tax Implications
6. Challenges and Opportunities
7. Q&A
1. Overview of new FASB Standard for leases

What is the impact to companies?

- $1.25 trillion in off balance sheet lease obligations being brought onto the balance sheet

  Based on 2005 estimates of SEC registrants

- Leads to $300 billion in possible deferred tax assets/liabilities

  Assuming Tax rate of 25% on 2005 SEC numbers

- Financial statement ratios and taxes paid may see big change

  Policies, processes, controls, and system capabilities will need to adjust accordingly
Understanding the new leasing standard

- Requires lessees to put most leases on their balance sheets but recognize expenses on their income statements in a manner similar to today’s accounting for finance leases.

- Eliminates today’s real estate-specific provisions.

- Requires entities to classify leases to determine how to recognize lease-related revenue and expense.

- Entities may be required to develop new processes and controls or adjust existing processes and controls to identify and account for leases.

- Allows entities to make policy choice to apply existing lease identification and classification conclusions; however asset and liabilities must still be booked on balance sheet (part of a package of transition-related expedients).

- FASB standard is not fully converged with IFRS 16 issued by International Accounting Standards Board (IASB).
Timeline

Modified retrospective – calendar year-end: CURRENTLY

1/1/2017

Public company transition

1/1/2018

Public company effective date

1/1/2019

Private company transition

1/1/2020

Private company effective date
FASB – Private Company **Proposed** Delay

- Who would the proposed delay include?
  - Private companies and NFPs that are not considered to be public business entities

- How long is the proposed delay?
  - The proposal is for a delay of the effective date by **one year** (or 2021 for annual reporting purposes)

- Why is a delay being proposed?
  - The adoption efforts have been greater than the FASB initially thought

- How and when could this proposal get finalized?
  - The tentative decision was made by the FASB in July 2019
  - The process to finalize any changes takes significant time – including a public comment period
2. Definition of a Lease

**Definition of a lease – key components**

**Identified asset**
- Physically distinct
- Explicitly or implicitly identified
- No substantive substitution rights

**Right to control use of the asset**
- Right to obtain substantially all economic benefits from use
- Right to direct the use

**Period of use**
- Time
- Output
Example #1
Asset supplied to customer

Customer
Determines whether truck is driven, how it is driven, and where it goes

Supplier
No substitution rights, responsible for general maintenance

Three year truck lease
Reminder definition of a lease

Three components

- Identified asset
- Right to control the use
- Period of time

= Lease
Reminder definition of a lease

Three components

Identified asset + Right to control the use + Period of time = Lease

Contract is a lease
Customer has right to direct how and for what purpose the asset is used
# Inception date vs. Commencement date

<table>
<thead>
<tr>
<th><strong>Inception date</strong></th>
<th><strong>Commencement date</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>when extraction process begins</td>
<td>when B/S recognition begins</td>
</tr>
</tbody>
</table>

- **Inception date**
  - Date the contract is executed

- **Commencement date**
  - Date a lessor makes an underlying asset available for the lessee’s use
  - Does not require the asset to be in use
3. Components of a contract

- **Lease component**: The portion of the contract that meets the definition of a lease.
- **Non-lease components**: Other provisions in the contract that require the lessor to transfer goods or services to the lessee.
- **Non-components**: Administrative tasks required to set up a contract or initiate a lease.
- **Reimbursement or payment of the lessor’s costs**:
Embedded Leases

Areas to consider for service contracts that could contain embedded leases:

- Equipment & Parts
- General Maintenance
- Operating Supplies & Safety
- Repair/Calibration
- Waste Service
- Maintenance, Repair, and Operations – Lease/Rental
- Specialty Items
- Industrial Cleaning
- Automation Controls
- Computer Software
- IT Services
- Telecommunications
- IT – Leasing/Rental
- Digital Hardware
- Computer Hardware
- Co-Manufacturing Services
- Co-Packaging arrangements
- Cafeteria services
Separate components of a contract

Identify and separate lease components of contract if components meet both of the following criteria:

1. Lessee can benefit from right to use either on its own or with readily available resources.
2. Right of use is neither highly dependent on nor highly interrelated with other rights of use in contract.
Example #2
Telecommunications Agreement

Customer
Customer does not operate the servers or make any other decisions about their use

Supplier:
Telecommunication Company
Install servers on customer premises in order to deliver services

Two year network services
Example #2

Identify the assets

- Each server is an identified asset
- Could be explicitly or implicitly identified

Identify the right to control use of the asset

- All economic benefit of server is used by customer on their premise
- However, the supplies determines the ultimate use

Identify the time of the assets

- 2 year contract
Example #2 Answer

Identify the assets

• Each server is an identified asset
• Could be explicitly or implicitly identified

Identify the right to control use of the asset

• All economic benefit of server is used by customer on their premise
• However, the supplies determines the ultimate use

Identify the time of the assets

• 2 year contract

Contract is a Service
Not within the scope of the new leases standard
Example #3
Retailer in Commercial Center

Customer:
Retailer
Retailer uses premises for its storefront that operates only when commercial center is open.

Supplier:
Real Estate Company
Provides location in commercial center which includes cleaning, advertising, and security services.

Five year contract
Example #3 Answer

Identify the assets
- Dedicated space in commercial center

Identify the right to control use of the asset
- Retailer has exclusive use of the shop
- Retailer can decide how to use the space

Identify the time of the assets
- 5 year contract
Example #3 Answer

Identify the assets

• Dedicated space in commercial center

Identify the right to control use of the asset

• Retailer has exclusive use of the shop
• Retailer can decide how to use the space

Identify the time of the assets

• 5 year contract

Contract is a Lease AND a Service
Example #4
Truck Rental Agreement

Customer:
Food Company
Company decides where, when and how it uses the trucks.

Supplier:
Truck Manufacturer
Provides use of ten refrigerated trucks with annual maintenance check and repairs.

Four year contract
Example #4 Answer

Identify the assets
• 10 separate trucks

Identify the right to control use of the asset
• Food company has exclusive use of the trucks
• Food company can decide how to use the trucks

Identify the time of the assets
• 4 year contract
Example #4 Answer

Identify the assets
• 10 separate trucks

Identify the right to control use of the asset
• Food company has exclusive use of the trucks
• Food company can decide how to use the trucks

Identify the time of the assets
• 4 year contract

Contract is a Lease AND a Service
4. Lessee Accounting
Measuring ROU assets and lease liabilities

<table>
<thead>
<tr>
<th>ROU asset</th>
<th>Lease liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease liability</td>
<td></td>
</tr>
<tr>
<td>+ Payments made before commencement</td>
<td></td>
</tr>
<tr>
<td>- Lease incentives</td>
<td></td>
</tr>
<tr>
<td>+ Initial direct costs</td>
<td></td>
</tr>
<tr>
<td>Present value of lease payments</td>
<td></td>
</tr>
</tbody>
</table>

*Note: Can elect to account for short term leases "off balance sheet"
Lease Classification

Classifying a lease – finance or operating

- Ownership transfers to lessee at end of lease term (No → Yes)
- Purchase option that is reasonably certain of being exercised (No → Yes)
- Lease term = major part of remaining economic life (e.g., 75%) (No → Yes)
- PV of lease payments + lessee RVG = substantially all of FV (e.g., 90%) (No → Yes)
- Specialized asset with no alternative use (No → Yes)

Finance

Operating
# Determining lease payments

<table>
<thead>
<tr>
<th>Include</th>
<th>Exclude</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Fixed payments and in substance fixed payments, reduced by lease incentives paid to the lessee</td>
<td></td>
</tr>
<tr>
<td>• Variable lease payments dependent on a rate or index</td>
<td></td>
</tr>
<tr>
<td>• Options for which exercise is reasonably certain</td>
<td></td>
</tr>
<tr>
<td>• Termination penalties if termination is reasonably certain</td>
<td></td>
</tr>
<tr>
<td>• Fees paid by the lessee to owners of a special-purpose entity for structuring the transaction</td>
<td></td>
</tr>
<tr>
<td>• Amount lessee is probable to owe under a residual value guarantee (lessee only)</td>
<td></td>
</tr>
<tr>
<td>• Variable lease payments not dependent on an index or a rate</td>
<td></td>
</tr>
<tr>
<td>• Guarantee of the lessor’s debt</td>
<td></td>
</tr>
<tr>
<td>• Amounts allocated to nonlease components</td>
<td></td>
</tr>
</tbody>
</table>
Payments dependent on an index/rate

**Example 1:** Payments are $10,000 in year 1, and increase annually by one month LIBOR at the end of each year. The lease term is 5 years and one month LIBOR at commencement is 2%.

Lessee uses one month LIBOR at commencement to project payments over the lease term. Therefore Lessee calculates lease payments of $52,040.

**Example 2:** Payments are $10,000 in year 1, and increase annually by the percentage increase in CPI during the year. The lease term is 5 years.

Lessee assumes that CPI at commencement will be the CPI throughout the lease. Lessee calculates lease payments of $50,000.
Example & Financial Statement Implications

Facts & Assumptions

- Lessee enters into a 3-yr building lease
- Annual payments made at the end of the year for 10k, 12k, 14k
- Assume it's an operating lease
- Assume no purchase options, payments made before commencement, lease incentives from the lessor, or initial direct costs
- Incremental borrowing rate is 3%
Example & Financial Statement Implications

Facts & Assumptions
- Lessee enters into a 3-yr building lease
- Annual payments made at the end of the year for 10k, 12k, 14k (Total - $36,000; PV - $33,382)
- Assume it's an operating lease
- Assume no purchase options, payments made before commencement, lease incentives from the lessor, or initial direct costs
- Incremental borrowing rate is 3%

Journal entry at lease commencement:
Right-of-use Asset  33,382
   Lease Liability  33,382

Journal entry at year end:
Lease Expense ($36k / 3)  12,000
   Cash (Yr. 1 Rent Exp)  10,000
   Right-of-use Asset  2,000

Lease Liability  8,985
   Right-of-use Asset (SL Exp – Interest)  8,985
## Financial Statement Implications – Ex cont.

### Balance Sheet Impact

<table>
<thead>
<tr>
<th></th>
<th>Lease Commencement</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Liability</td>
<td>33,832</td>
<td>24,847</td>
<td>13,592</td>
<td>0</td>
</tr>
<tr>
<td>Right-of-use Asset</td>
<td>33,832</td>
<td>22,847</td>
<td>11,592</td>
<td>0</td>
</tr>
</tbody>
</table>

### Income Statement Impact

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Expense</td>
<td>12,000</td>
<td>12,000</td>
<td>12,000</td>
</tr>
</tbody>
</table>

### Cash Flow Statement Impact

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Paid</td>
<td>10,000</td>
<td>12,000</td>
<td>14,000</td>
</tr>
</tbody>
</table>

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Key change for lessees
Financial Statement Implications – Ex 6

Facts & Assumptions
- Lessee enters into a 3-yr building lease
- Annual payments made at the end of the year for 10k, 12k, 14k
- Assume it's an operating lease
- The lessor is providing 5k in leasehold improvements, paid at the end of year 1
- Assume no purchase options, payments made before commencement, or initial direct costs
- Incremental borrowing rate is 3%

Journal entry at lease commencement:
Right-of-use Asset 28,978
    Lease Liability 28,978

Journal entry at year end:
Lease Expense 10,333
    Cash 5,000
    Right-of-use Asset 5,333

Lease Liability 4,131
    Right-of-use Asset 4,131
Financial Statement Implications – Ex 6 cont.

### Balance Sheet Impact

<table>
<thead>
<tr>
<th></th>
<th>Lease Commencement</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
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<td>Lease Liability</td>
<td>28,978</td>
<td>24,847</td>
<td>13,592</td>
<td>0</td>
</tr>
<tr>
<td>Right-of-use Asset</td>
<td>28,978</td>
<td>19,513</td>
<td>9,926</td>
<td>0</td>
</tr>
</tbody>
</table>

### Income Statement Impact

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease Expense</td>
<td>10,333</td>
<td>10,333</td>
<td>10,333</td>
</tr>
</tbody>
</table>

### Cash Flow Statement Impact

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Paid</td>
<td>5,000</td>
<td>12,000</td>
<td>14,000</td>
</tr>
</tbody>
</table>

Key change for lessees
Ratio Implications

Key impact of the additional lease assets and lease liabilities are likely going to result in:

- Lower liquidity ratios because of the increased current liabilities, such as:
  - Current ratio (current assets / current liabilities)
  - Quick ratio ((cash + short-term investments + receivables) / current liabilities)

- Higher working capital turnover (revenue / average working capital) due to reduced working capital because the lease liability is partially current

- Lower asset turnover (revenue / average total assets) due to increased total assets

The liabilities related to operating leases are categorized as operating liabilities NOT debt-like liabilities and therefore may not significantly effect debt-based ratios.

This would include the following ratios: debt-to-capital (total debt / (total debt + total equity)), debt-to-equity (total debt / total equity), and weighted-average cost of capital
# Lessee Subsequent Re-measurement

<table>
<thead>
<tr>
<th>Lessee shall remeasure lease payments when</th>
<th>A modification is not accounted for as a separate contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingency related to variable payments is resolved (except for changes in index or rate)</td>
<td></td>
</tr>
<tr>
<td>Change in lease term</td>
<td></td>
</tr>
<tr>
<td>Change in assessment whether lessee is reasonably certain to exercise purchase option</td>
<td></td>
</tr>
<tr>
<td>Change in amounts probable of being owed by lessee under residual value guarantee</td>
<td></td>
</tr>
</tbody>
</table>
## Reassessment of lease term

<table>
<thead>
<tr>
<th>A significant event or change in circumstances within lessee's control</th>
<th>Event in the contract obligates the lessee to exercise an option</th>
<th>Lessee elects to exercise an option</th>
<th>Lessee elects not to exercise an option</th>
</tr>
</thead>
</table>

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Reassessment of lease term

Examples of events that should warrant reconsideration of an option

| Constructing significant leasehold improvements | Making significant modifications to underlying asset | Making business decisions that affect future use of the asset | Subleasing for a period beyond the exercise date of a renewal option |
## 5. Disclosures & Transition

**Disclosures – enable users to assess cash flows from leases**

<table>
<thead>
<tr>
<th>Qualitative disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• General description of lease</td>
</tr>
<tr>
<td>• Basis and terms and conditions of variable lease payments, extension and termination options, and residual value guarantees</td>
</tr>
<tr>
<td>• Restrictions or covenants imposed by leases</td>
</tr>
<tr>
<td>• Significant assumptions and judgments made in identifying a lease, allocation of lease consideration, lease term, and discount rate</td>
</tr>
<tr>
<td>• Significant rights and obligations for leases not yet commenced</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quantitative disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Finance lease cost (separating amortization and interest cost)</td>
</tr>
<tr>
<td>• Operating lease cost</td>
</tr>
<tr>
<td>• Short-term lease cost</td>
</tr>
<tr>
<td>• Variable lease cost</td>
</tr>
<tr>
<td>• Separately for finance and operating leases: cash paid, weighted-average remaining lease term, weighted-average discount rate, supplemental noncash information about lease liabilities recognized from obtaining ROU assets, maturity analysis of undiscounted lease cash flows and a reconciliation of undiscounted cash flows to lease liabilities</td>
</tr>
</tbody>
</table>
ASC 842 Practical Expedients

1. Package of Practical Expedients for Transition

This expedient allows an entity to not reassess during transition the:

1. definition of a lease,
2. lease classification, and
3. initial direct costs for existing leases

The intent of this practical expedient was to provide entities, who have reported with good faith under ASC 840, the opportunity to leverage that work and have significant cost/effort savings from not being required to reassess previous accounting conclusions. Entities can make this accounting policy election on an entity-wide basis (that is, it would apply to all leases) and are required to disclose the use of this election.
2. Use of Hindsight during Transition

This allows an entity to use hindsight in determining the lease term and assessing impairment of the leased asset during transition.

Unlike the package of practical expedients which allows an entity to not reassess, this expedient allows an entity to reassess. While there are circumstances that this may be beneficial to entities, it is important to consider whether this election passes the cost vs. benefit test.

Entities can make this accounting policy election on an entity-wide basis (that is, it would apply to all leases) and are required to disclose the use of this election.
3. Short-Term Exception

This expedient allows lessees with leases that have a term of 12 months or less* to be accounted for similar to existing operating leases.

The expedient is a recognition exemption, which means that these leases are still considered to be within the scope of ASC 842, but are not required to be recognized on the balance sheet. This is important from a disclosure perspective, as certain disclosures (such as the election of the exemption and the lease cost for short-term leases) are required.

Lessees can make this accounting policy election based on class of underlying asset (for example, office equipment, automobiles, etc.).

*Leases that are 1 month or less are not included in the disclosures (para 842-20-50-4(c)).
ASC 842 Practical Expedients

4. Lessee – Election to not Separate Non-lease Components

This expedient allows lessees to not separate lease and non-lease components and to account for both components as a single component, recognized on the balance sheet.

An example of a contract with lease and non-lease components would be a lease for equipment that includes maintenance, which are both provided by the lessor. ASC 842 requires the lessee to separate the equipment and maintenance, as only the equipment (the lease component) is recognized on the balance sheet.

If elected, the lessee would not separate the components and would recognize the total consideration in the contract on the balance sheet. The result is increased lease liabilities and leased assets, but potentially reduced implementation costs. Lessees can make this accounting policy election based on class of underlying asset and are required to disclose the use of this election.
ASC 842 Practical Expedients

5. Additional Transition Method/Relief

The Board decided to amend ASC 842 to provide entities with an additional transition method with which to adopt ASC 842. The transition method enables entities to apply the transition requirements in ASC 842 at the effective date of that ASC (rather than at the beginning of the earliest comparative period presented as currently required) with the effects of initially applying ASC 842 recognized as a cumulative-effect adjustment to retained earnings in the period of adoption.

Consequently, an entity’s reporting for the comparative periods presented in the year of adoption would continue to be in accordance with ASC 840, including the disclosure requirements of that ASC.
6. Land Easement Transition Relief

This relief impacts entities that have land easements (also commonly referred to as rights of way) that represent the right to use, access, or cross another entity’s land for a specified purpose. Recognizing current diversity in practice, the Board issued an update to ASC 842 whereby there is an optional transition practical expedient to not evaluate under ASC 842 existing or expired land easements that were not previously accounted for as leases under ASC 840.

Beginning at the date that the entity adopts ASC 842, an entity should evaluate any new or modified land easements in accordance with the definition of a lease guidance in ASC 842.
Tax Accounting Impact of ASC 842

- Tax has no basis in ROU asset being used for GAAP
- Results in differences between book and tax treatment
- Each lease has deferred tax assets/liabilities, some greater than others
- "Flag" leases for further evaluation by the tax department
Loss of Visibility

Ledger Detail
- Prepaid / Deferred Rent
- Initial Direct Costs
- Lease Incentives

After 842

ROU Asset
- Initial Direct Costs
- Prepaid / Deferred Rent
- Lease Incentives

Deferred Calculation
Other Tax Considerations

Income Tax Apportionment
Possible change of state effective tax rate due to having income tax nexus in states with property factor

Franchise, Net Worth and Similar Taxes
Tax bases on net worth or asset balance may be affected by the right-of-use assets recorded under new standard

Personal Property and Real Estate
Taxing authorities may claim that the right-of-use asset subjects them to tax

Sales and Use Tax
Some jurisdictions impose tax on rentals of tangible personal property and new standard may impact timing of obligation
6. Challenges & Opportunities

New **challenges** for managing leases under 842

1. Classifying leases vs. services
2. Gathering data from decentralized sources with inconsistent processes
3. Inadequate systems, lack of common structure in documents, and managing lease renegotiations
4. Staying compliant after transition
Areas potentially requiring change

- Updated accounting policies and disclosures
- New application of judgment and estimation
- Updates or overhauls to related internal controls
- New systems to capture, process, and maintain lease data
- Adjusted income and other taxes
- Revised debt covenant compliance
Silver linings: Unplanned benefits

- Better lease decisions
  - Stronger leverage for lease negotiations
  - Improved systems and lease processes based on best practices
  - Stronger controls and standardized policies
  - Management insight through centralized information

- Better business decisions
  - Clearer decisions on leasing vs. services
  - Stronger debt covenants