ASC 842: Leasing Standards

July 29, 2019

Amanda Richardson
Partner, Tax
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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Assuming Tax rate of 25% on 2005 SEC numbers

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

- Financial statement ratios and taxes paid may see big change

Policies, processes, controls, and system capabilities will need to adjust accordingly

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Understanding the new leasing standard

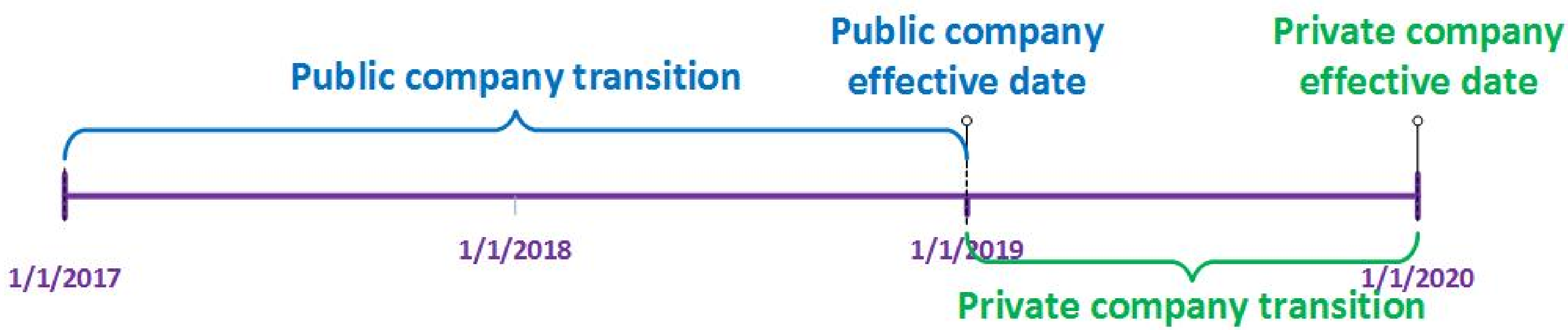
- Requires lessees to put most leases on their balance sheets but recognize expenses on their income statements in a manner similar to today's accounting for finance leases
- Eliminates today's real estate-specific provisions
- Requires entities to classify leases to determine how to recognize lease-related 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)

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Timeline

Modified retrospective – calendar year-end: CURRENTLY



© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

GrantThornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Example #1

Asset supplied to customer

Customer

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

Three year truck lease

Supplier

No substitution rights, responsible for general maintenance

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Reminder definition of a lease

Three components

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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Reminder definition of a lease

Three components

Contract is a lease
Customer has right to direct how and for what purpose the asset is used

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

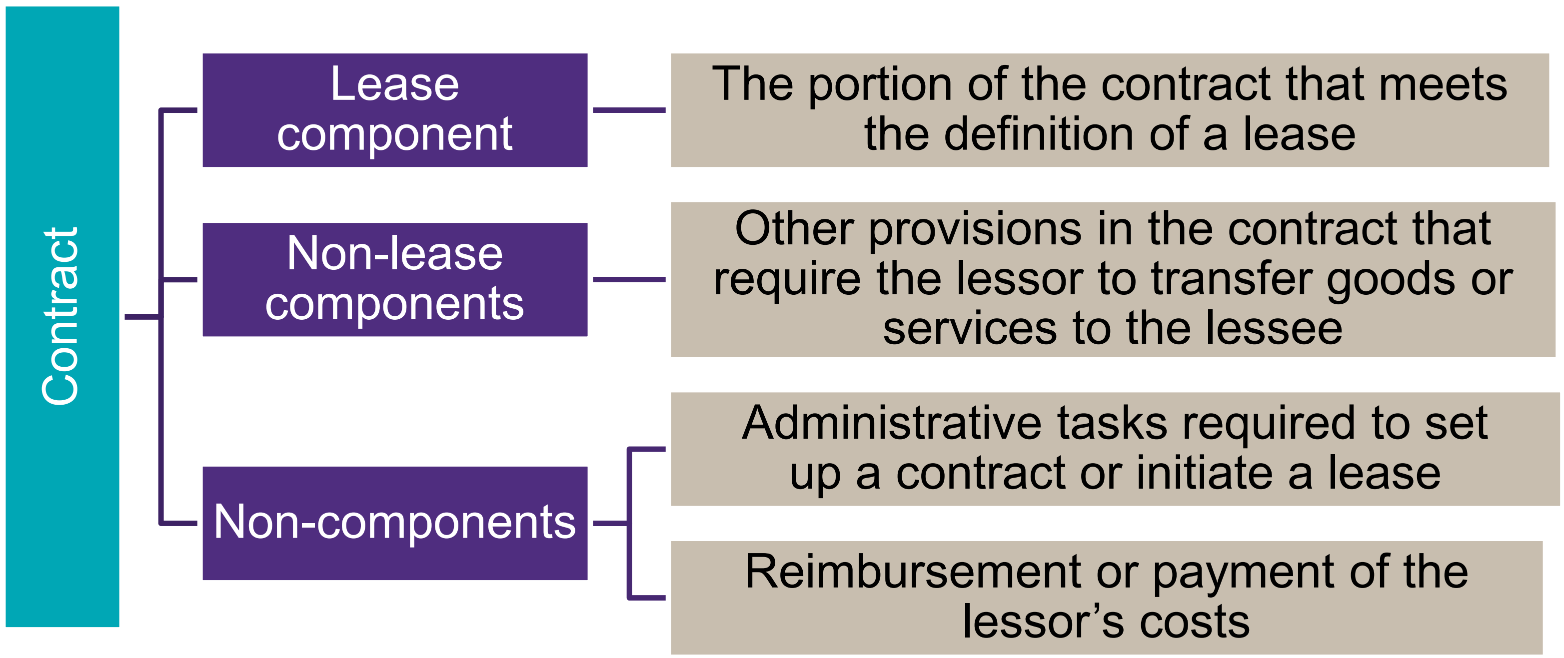
Inception date vs. Commencement date

Inception date - when extraction process begins	• Date the contract is executed
Commencement date - when B/S recognition begins	• Date a lessor makes an underlying asset available for the lessee's use • Does not require the asset to be in use

Grant Thornton

© Grant Thornton LLP. All rights reserved.

3. Components of a contract



Embedded Leases

Areas to consider for <u>service contracts</u> 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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Separate components of a contract

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

- Lessee can benefit from right to use either on its own or with readily available resources
- Right of use is neither highly dependent on nor highly interrelated with other rights of use in contract

Grant Thornton

© Grant Thornton LLP. All rights reserved.

Example #2

Telecommunications Agreement

Customer

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

Two year network services

Supplier:

Telecommunication Company

Install servers on customer premises in order to deliver services

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Example #3

Retailer in Commercial Center

Customer:
Retailer

Retailer uses premises for it’s storefront that operates only when commercial center is open.

Five year contract

Supplier:
Real Estate Company

Provides location in commercial center which includes cleaning, advertising, and security services.

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Example #4

Truck Rental Agreement

Customer:
Food Company

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

Four year contract

Supplier:
Truck Manufacturer

Provides use of ten refrigerated trucks with annual maintenance check and repairs.

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

4. Lessee Accounting

Measuring ROU assets and lease liabilities

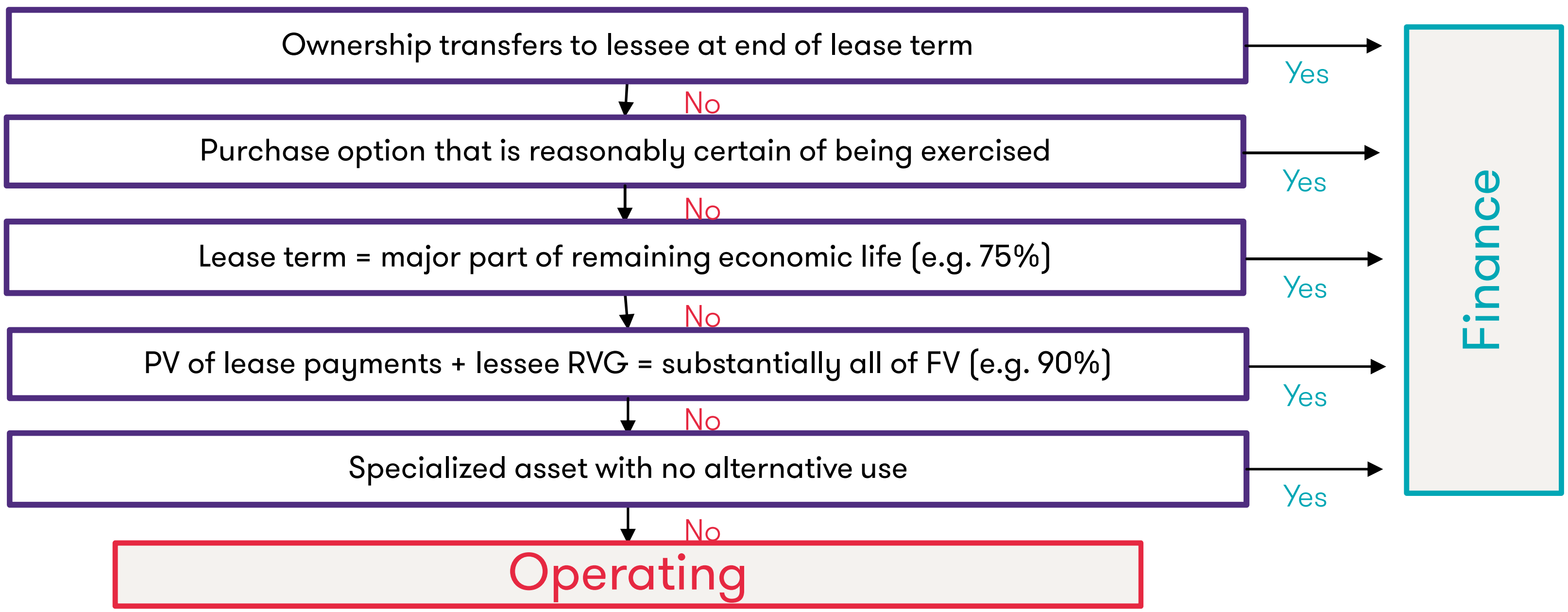
ROU asset	Lease liability
Lease liability + Payments made before commencement - Lease incentives + Initial direct costs	Present value of lease payments

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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Lease Classification

Classifying a lease – finance or operating



© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Determining lease payments

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

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.

© Grant Thornton LLP. All rights reserved.

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%

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Financial Statement Implications – Ex cont.

Balance Sheet Impact

	Lease Commencement	Year 1	Year 2	Year 3
Lease Liability	33,832	24,847	13,592	0
Right-of-use Asset	33,832	22,847	11,592	0

Income Statement Impact

	Year 1	Year 2	Year 3
Lease Expense	12,000	12,000	12,000

Cash Flow Statement Impact

	Year 1	Year 2	Year 3
Cash Paid	10,000	12,000	14,000

Key change for lessees

GrantThornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Financial Statement Implications – Ex 6 cont.

Balance Sheet Impact

	Lease Commencement	Year 1	Year 2	Year 3
Lease Liability	28,978	24,847	13,592	0
Right-of-use Asset	28,978	19,513	9,926	0

Income Statement Impact

	Year 1	Year 2	Year 3
Lease Expense	10,333	10,333	10,333

Cash Flow Statement Impact

	Year 1	Year 2	Year 3
Cash Paid	5,000	12,000	14,000

Key change for lessees

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Lessee Subsequent Re-measurement

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

Grant Thornton

© Grant Thornton LLP. All rights reserved.

Reassessment of lease term

Events that would cause a lessee to reassess the lease term			
A significant event or change in circumstances within lessee's control	Event in the contract obligates the lessee to exercise an option	Lessee elects to exercise an option	Lessee elects not to exercise an option

Grant Thornton

© Grant Thornton LLP. All rights reserved.

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

Grant Thornton

© Grant Thornton LLP. All rights reserved.

5. Disclosures & Transition

Disclosures – enable users to assess cash flows from leases

Qualitative disclosures	• General description of lease • Basis and terms and conditions of variable lease payments, extension and termination options, and residual value guarantees • Restrictions or covenants imposed by leases • Significant assumptions and judgments made in identifying a lease, allocation of lease consideration, lease term, and discount rate • Significant rights and obligations for leases not yet commenced
Quantitative disclosures	• Finance lease cost (separating amortization and interest cost) • Operating lease cost • Short-term lease cost • Variable lease cost • 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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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.

ASC 842 Practical Expedients

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.

ASC 842 Practical Expedients

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.

ASC 842 Practical Expedients

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

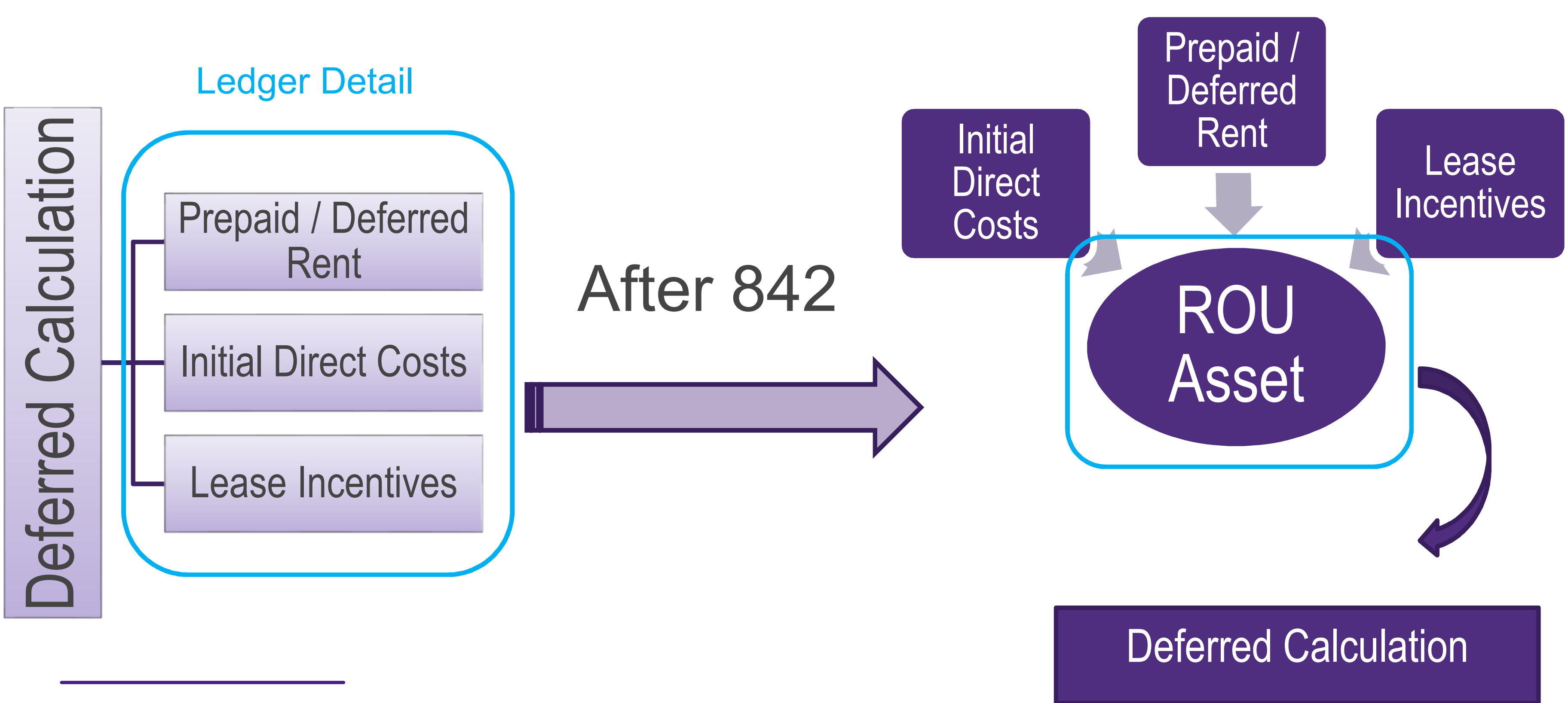
Results in differences between book and tax treatment

Each lease has deferred tax assets/liabilities, some greater than others

"Flag" leases for further evaluation by the tax department

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Loss of Visibility



© Grant Thornton LLP. All rights reserved.

Other Tax Considerations

Income Tax Apportionment	Franchise, Net Worth and Similar Taxes	Personal Property and Real Estate	Sales and Use Tax
Possible change of state effective tax rate due to having income tax nexus in states with property factor	Tax bases on net worth or asset balance may be affected by the right-of-use assets recorded under new standard	Taxing authorities may claim that the right-of-use asset subjects them to tax	Some jurisdictions impose tax on rentals of tangible personal property and new standard may impact timing of obligation

Grant Thornton

© 2017 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

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

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd

Q&A

Grant Thornton

© 2018 Grant Thornton LLP | All rights reserved | U.S. member firm of Grant Thornton International Ltd