2022 MCM NFP Summit

Leases, Topic 842 (ASU 2016-02)

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Quick hitters

Overview

FASB's Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)* is intended to increase transparency and comparability in financial reporting by requiring balance sheet recognition of leases and enhanced footnote disclosures related to lease arrangements.

EFFECTIVE DATE

Public business entities, certain not-for-profit entities with conduit financing arrangements, and employee benefit plans – Fiscal years as well as interim periods beginning after **December 15, 2018**.

All other entities – Fiscal years beginning after **December 15, 2021**. Interim periods within fiscal years beginning after **December 15, 2022.**

Scope

- Topic 842 guidance includes leases of all property, plant and equipment (PP&E) and excludes:
  - Leases of intangible assets
  - Leases to explore for or use non-regenerative resources (i.e. oil, natural gas)
  - Leases of biological assets (including timber)
  - Leases of inventory
  - Leases of assets under construction

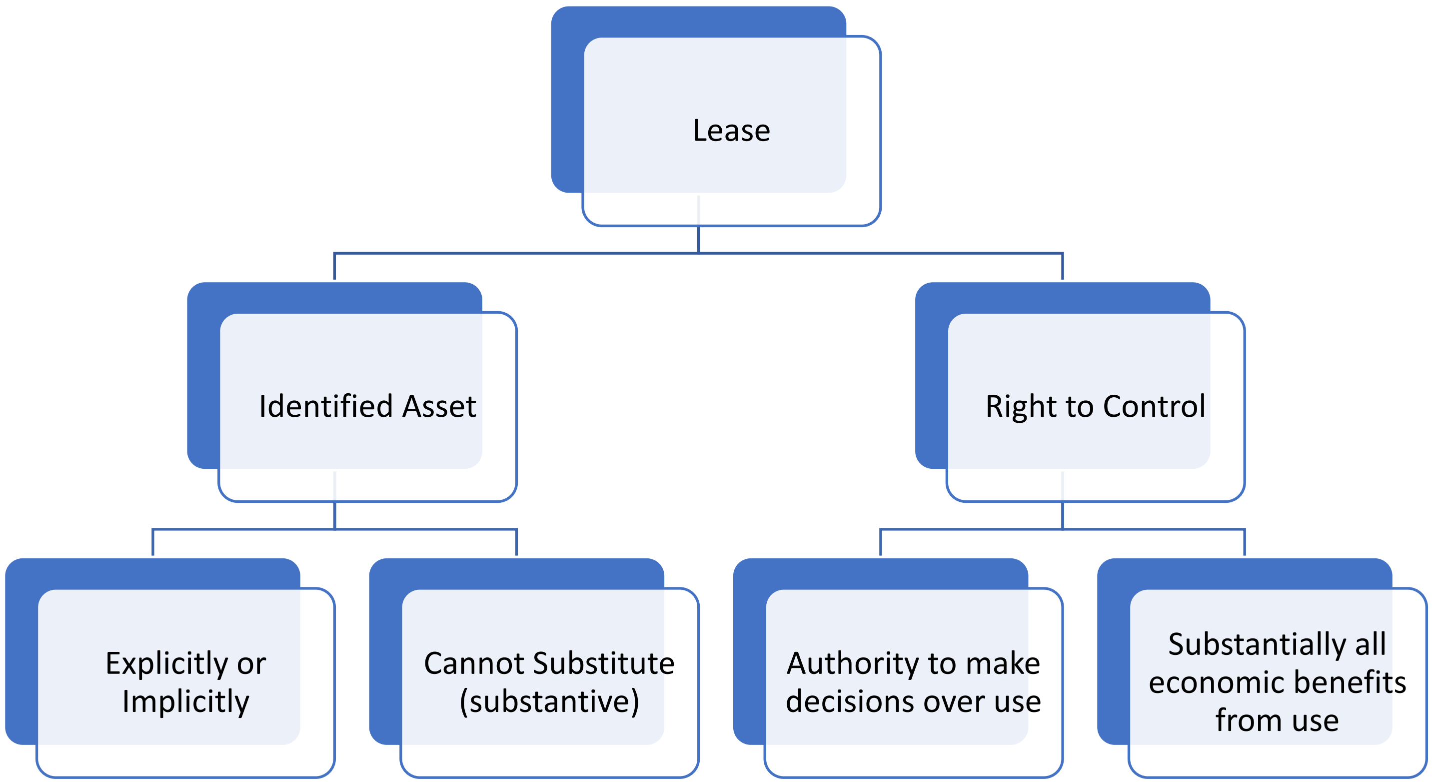
Key Changes - Lessee

Requires recognition of most leases on the **balance sheets** as lease liabilities with corresponding right-of-use (ROU) assets*

Recognize expenses on the **income statements** in a manner similar to today's accounting

*Requires impairment testing for new ROU assets

Identifying a Lease



Note: **<u>Must have both</u>** an identified asset **<u>and</u>** right to control

Lessee Classification

Classification will be determined in accordance with the principles in current lease requirements, but without the bright-line tests (e.g. by determining whether a lease is effectively an installment purchase by the lessee)

- Lease will be classified as a "finance lease" if it transfers substantially all risks & rewards associated to ownership (*meets one of the 5 criteria on the next slide*)

- All other leases will be classified as "operating leases" by lessee and contain of ROU Asset and Lease Liability*
  - *Lessee exemption for leases with a term of 12 months or less
  - Note: IASB has low value lease exemption as well ($5K).
    - FASB – consider capitalization threshold

Scope

Finance Lease Criteria (Sales-Type for Lessor)				
Ownership Transfer	**Option to purchase that is reasonably certain**	**Lease term for "major part" of economic life***	**PV of payments equals or exceeds "substantially all" of the fair value**	**NEW: Asset is specialized (no alt use for lessor)**

*Lessees (and lessors) are afforded an exception to the lease classification test and do not need to consider this criterion for leases that commence "at or near the end" of the underlying asset's economic life (e.g. in the final 25% of an asset's economic life).

Lessee Accounting – Initial Measurement

Lease liability – measured initially at the present value of the lease payments

Right-of-use asset – measured initially at the present value of lease payments and adjusted for lease payments made before commencement, lease incentives received, and initial direct costs.

Discount Rate:

- Lessee should use rate the lessor charges (if implicit in the lease) or its own incremental borrowing rate.
- Entities that are not public can make accounting policy election to use the risk-free rate (ASU No. 2021-09 – *Leases (Topic 842) – Discount Rate for lessees That Are Not Public Business Entities.*

Lessee Accounting – Initial Measurement

Lease liability – measured initially at the present value of the lease payments

Right-to-use asset – measured initially at the present value of lease payments and adjusted for lease payments made before commencement, lease incentives received, and initial direct costs.

- When measuring, lessee should exclude most variable lease payments, other than those that depend on an index/rate or are in substance fixed payments.
- Exclude non-lease (i.e. service) components of lease contracts.
  - Requires allocation lease payment btw lease and non-lease
- Lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead account for as a single component.

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**

"Reasonably certain" - defined same as "reasonably assured" in current guidance. Includes consideration of factors at lease commencement date that would create economic incentive for the lessee to exercise (or not exercise).

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) & interest payments (operating activities)

***Periodically reduced by straight-line amortization**

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

**Periodically reduced by the difference between straight-line lease expense & interest cost on lease liability, *i.e.*, "plug figure"

Impact to Debt Agreements

- Covenant compliance (typical ratios):
  - Basic fixed charge coverage
  - Current ratio/Working capital
  - Debt service coverage
  - Debt to net worth
  - Funded debt to EBITDA

ASC 842 Effects Illustrated

	Current	ASC 842	Diff.
Current Assets	2,500,000	2,500,000	-
Noncurrent Assets	5,000,000	6,275,000	1,275,000
Total Assets	7,500,000	8,775,000	1,275,000
Current Liabilities	1,500,000	1,845,000	345,000
Noncurrent Liabilities	5,000,000	5,930,000	930,000
Total Liabilities	6,500,000	7,775,000	1,275,000
Equity	1,000,000	1,000,000	-
Current ratio	*1.67*	*1.36*	
Debt to equity	*6.50*	*7.78*	

Complexities

Transition

- Transition Method
  - Vast majority continue to use the Effective Date Method (vs. Comparative Method)
  - Effective Date Method
    - Requires 840 and 842 disclosures if elected and presenting comparative statements
      - Future Min. Lease Pmts under 840 required to be listed as of latest balance sheet presented under 840
      - Some public companies got into trouble with compliance on 840 disclosures.

- Applies to <u>all</u> outstanding leases, not just new leases

Transition

+ Practical Expedients

1. Package practical expedient – allows for no look back at reassessment of prior lease classification, initial direct costs, and assessment of embedded leases (all or nothing for all leases)

2. Ability for hindsight – in evaluating lessee options to extend/terminate/purchase underlying assets

3. Period of application/presentation – apply as of 1/1/22 the effective date of standard

What to Do Now

- Educate your team on the definition of a lease contract as defined under the new standard.
- Inventory your contracts and ensure communication between your accounting teams and all departments.
- Consider transition options and practical expedients.
- Consider impact to financial statements, including debt covenants. Communicate with users of your financial statements.
- Consider impact to month-end reporting and future tracking.

Software Solution

- Many situations will prompt or require use of a software solution
- Our software solution is here and available for us to help your team
- Similar to depreciation schedules – maintains independence
- Considerations for Candidates
  - If handling more than 10 leases, Excel not likely an effective solution
  - Suited best for those with 5-100 leases
  - Cost-effective solution, particularly after year 1.
  - Provides balances, journal entries, disclosures.

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