Welcome!

MCM Annual Update 2022

ASC Topic 842 Leases (ASU 2016-02)

Overview

- FASB ASC 842 (February 2016) – Concluded 10-year joint project with the IASB to improve financial reporting of leasing activities

- Why?
  - More faithful representation of a lessee's rights and obligations arising from leases
  - Fewer opportunities for entities to structure leasing transactions to achieve a particular outcome on the balance sheet
  - Improvements in the understanding and comparability of a lessee's financial statements
  - Alignment of lessor accounting and sale and leaseback transactions with comparable revenue guidance in the revenue recognition standard
  - Additional information about lessor's leasing activities and exposure to credit and asset risk as a result of leasing

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

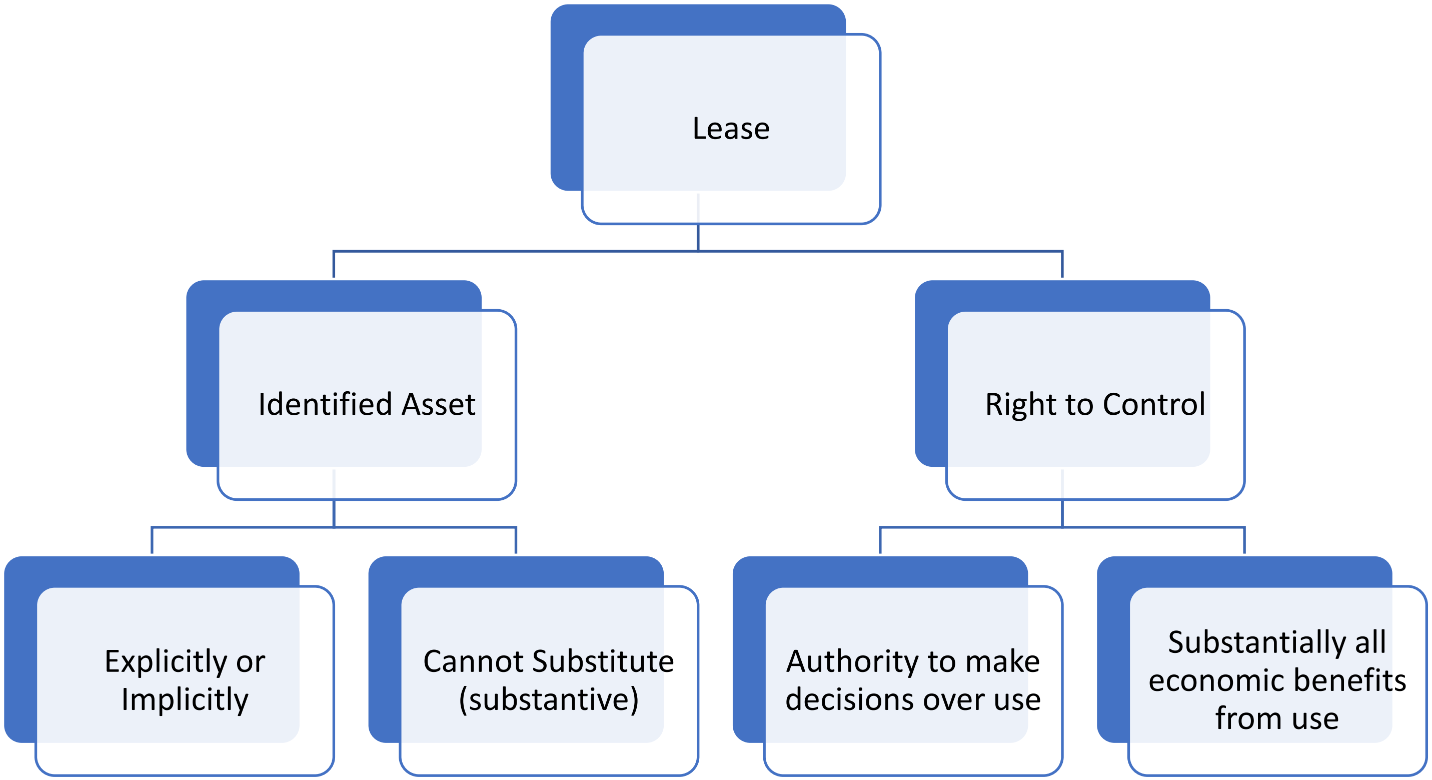
Key Changes - Lessee

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-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.

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).

Economic Incentive

Consider all economic factors relevant to that assessment (i.e., factors that create an economic incentive for the lessee) when considering lease term/renewals:

Contract-based – contractual terms and conditions for the optional periods compared with current market rates

Asset-based – Significant leasehold improvements that are expected to have significant economic value for the lessee when the option to extend or terminate the lease or to purchase the underlying asset becomes exercisable.

Market-based – Costs relating to the termination of the lease and the signing of a new lease, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's operations, or costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location

Entity-based - The importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset and the location of the underlying asset

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"

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*	

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

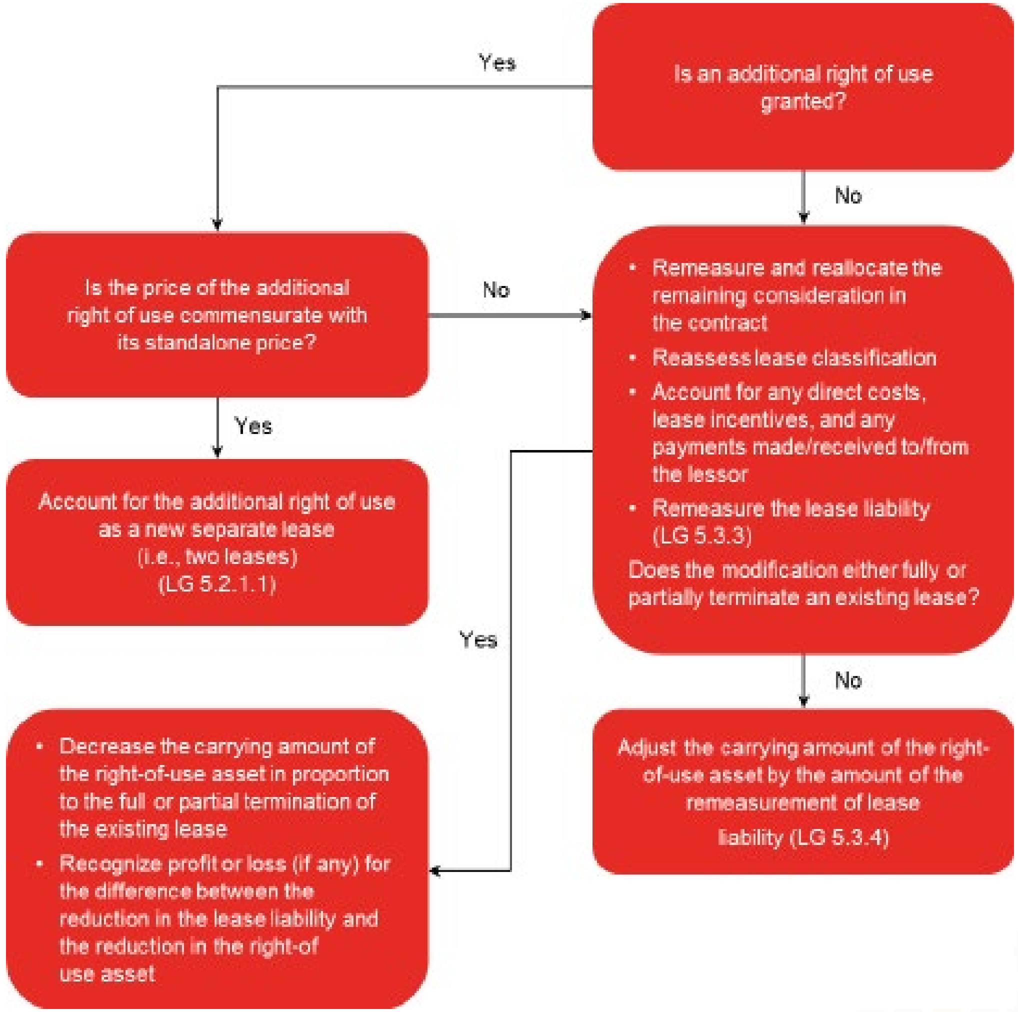
Complexities

Lease Modifications

- Lease modification – a change to the terms and conditions of a contract that results in a change in the scope of or the consideration for a lease
  - Examples:
    - Lease extension
    - Early termination of lease
    - Change in timing of lease payments
    - Leasing additional space in the same building

- When a lease modification occurs, the lessee has to determine whether the lease modification will be accounted for as a separate contract or as a change to the existing contract

Analysis of a Change in a Lease



Lease Modification - Separate Contract

- An entity shall account for a modification to a contract as a separate contract when both of the following conditions are present:
  - The modification **grants the lessee an additional right of use** not included in the original lease.
  - The lease **payments increase commensurate with the standalone price for the additional right of use**. For example, leasing an additional floor in an office building in which the lessee already leases another floor may be different from the standalone price of a similar floor in a different office building.
- When a lessee concludes that a lease modification should be accounted for as a new lease that is separate and apart from the original lease, the accounting for the original lease is not changed as a result of the lease modification.

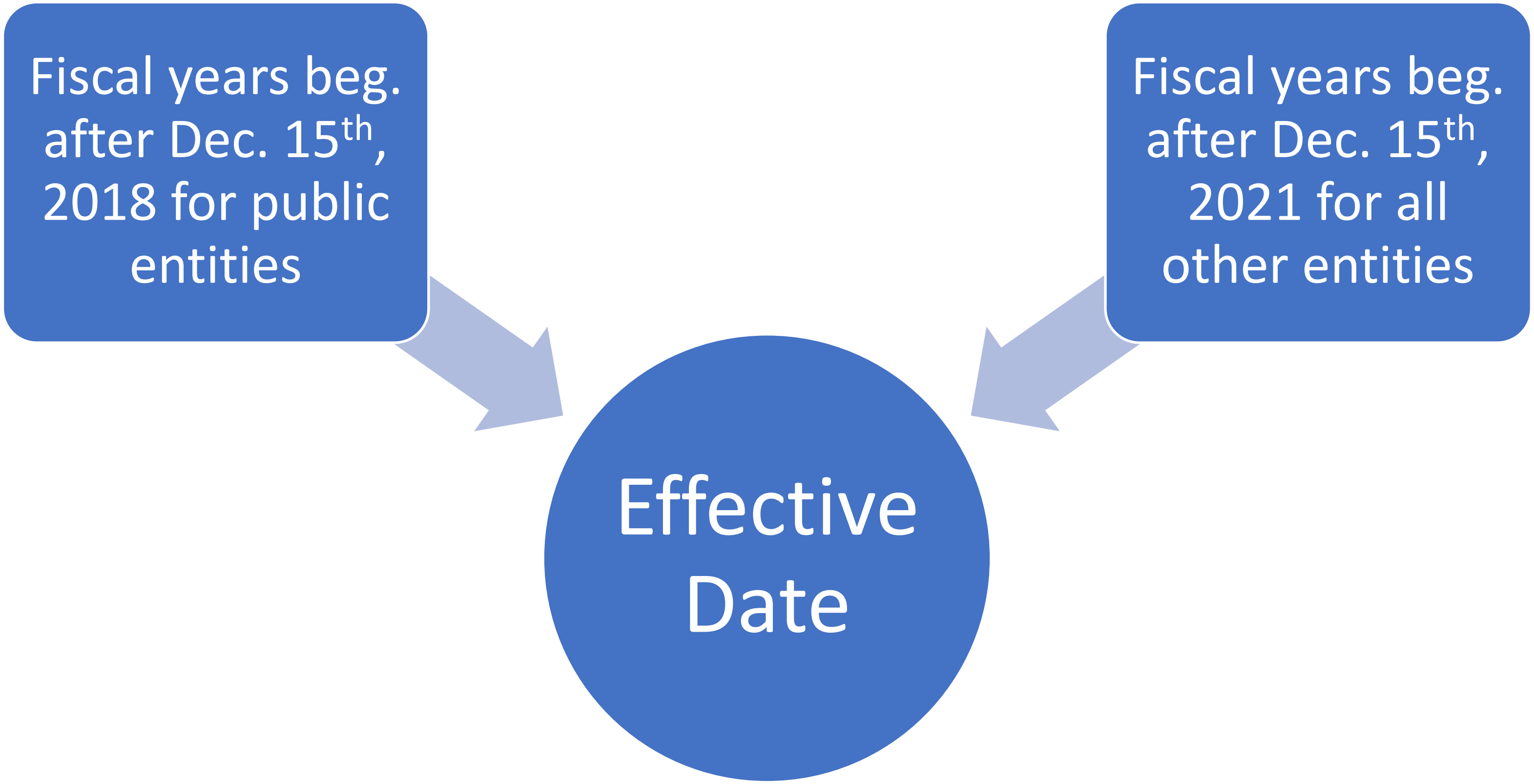
Lease Modification – Same Contract

+ If the lease modification is not accounted for as a separate contract, an entity is required to reassess classification of the lease (finance versus operating) as of the effective date of the modification based on the modified terms and conditions and the facts and circumstances as of that date

Remeasurement

Remeasurement of ROU asset and lease liability required when:	When to reassess:
• Modification of a lease that is not accounted for as a separate contract	Upon modification
• Change in lease term • Change in assessment of purchase option being exercised	Only when there is a triggering event
• Change in amount probable of being owed under a RVG • Resolution of a contingency	Whenever relevant facts and circumstances change

Timing



Note: *Most debt agreements will be renewed prior to effective date.*

Transition

- Modified retrospective approach (assets & liabilities measured at implementation date over remaining life of lease; specific guidance provided)
  - Lessees - Transition method applies to all capital & operating leases
  - Lessors - Applies to all sales-type, direct financing & operating leases (leveraged leases grandfathered, but otherwise phased out)

- 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

Related Party Leases

- Explicit terms of the lease unless other transactions (i.e. leasehold improvements) indicate otherwise or unless explicit is clearly uneconomic (see previous slide)

Related Party Leases - Update

- FASB proposal for practical expedient for leases between entities under common control:
  - Nonpublic entities
  - Allows using written terms and conditions of lease to determine if 842 applies and accounting conclusion
  - Does not require determination of legal enforceability of written lease
  - If no written terms, still apply 842 based on legally enforceable terms (could allow short term lease exemption for oral leases)
  - Allows amortizing LHIs over economic life of asset without regard to length of lease

Significant Disclosures

+ Weighted avg. remaining lease term separate for finance and operating leases
+ Weighted avg. discount rate separate for finance and operating leases
+ Accounting policy/practical expedient elections
+ Finance/Operating ROU asset and lease liability (if not presented separate in balance sheet)
+ Separate lease maturity tables for finance and operating leases with reconciliation to lease liabilities (similar to capital lease disclosures under 840

Current Status:

- Balance sheet – impacted
- Income statement – limited
- Most are selecting package of 3 practical expedients
- Most electing to avoid segregating lease and non-lease components
- Few using implicit rate and challenges to determine IBR
- Almost all did NOT adjust prior periods
- Software considerations for some industries

Let MCM Help!

- Software solution to assist clients
- Client conversations
  - If handling more than 10 leases, Excel will be very difficult to manage
  - Clients with 5-99 leases
  - Cost-effective solution year 1 and forward
  - Can provide balances, journal entries, disclosures

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PEOPLE MATTER

LEADERS INSPIRE

EXCELLENCE RULES

Certain Accounting Standards Updates

December 8, 2022

Presenter

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Agenda

- Accounting Standards Updates effective with fiscal years beginning after 12.15.21 (12.31.22 year-ends)
  - ASU 2016-02 - thanks Ryan!
  - ASU 2017-04 (and ASU 2021-03)
  - ASU 2021-07
  - ASU 2021-10
  - ASU 2020-04
  - ASU 2019-12
- Accounting Standards Updates effective with fiscal years beginning after 12.15.22 (12.31.23 year-ends)
  - ASU 2016-13

ASU 2016-02

- Financial Accounting Standards Board Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842)*
- Private companies - effective with fiscal years beginning after 12.15.21 (12.31.22 year-ends); early adoption permitted

ASU 2017-04

- ASU 2017-04, *Intangibles-Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*
- Private companies - effective on a prospective basis with fiscal years beginning after 12.15.21 (12.31.22 year-ends); early adoption permitted
- Simplifies the goodwill impairment test, providing a level of time and cost savings
- Eliminates "step 2" in the goodwill impairment test - comparing the implied fair value of the reporting unit with the carrying amount of goodwill; determining the fair value of assets and liabilities as if acquired/assumed in a business combination is no longer required
- Compare the fair value of a reporting unit with its carrying amount

ASU 2021-03

- ASU 2021-03, *Intangibles-Goodwill and Other (Topic 350): Accounting Alternative For Evaluating Triggering Events*
- Private companies only - effective on a prospective basis with fiscal years beginning after 12.15.19 (12.31.20 year-ends); early adoption permitted
- Private companies suggested the costs and complexity of monitoring and evaluating triggering events throughout the reporting period outweighs the benefits to the users of the financial statements; targeted relief to private companies (and non-profit entities)
- Provides an accounting alternative to perform a goodwill impairment triggering event evaluation as of the end of the reporting period, rather than monitoring for goodwill related triggering events throughout the reporting period
- No longer need to perform an events-driven triggering event assessment and record impairment as of the date of the triggering event

ASU 2021-07

- ASU 2021-07, *Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards*
- Private companies only - effective with qualifying awards granted (or modified) during fiscal years beginning after 12.15.21 (12.31.22 year-ends); early adoption permitted
- Practical expedient for private companies
- May determine the current price input of equity-classified share-based awards (applies to awards to both employees and non-employees) using the "reasonable application of a reasonable valuation method"
- The ASU defines the characteristics of a "reasonable valuation method,“ the same characteristics used in Treasury Regulations for income tax purposes (i.e., a 409A valuation)
- The current price input is the most difficult input for private companies to estimate since equity shares are often not actively traded to create observable market prices for the same or similar shares (and can be costly)
- Does not apply to liability-classified awards which are required to be re-measured as of each reporting period
- Valuations permitted
  - Independent third-party appraisal/valuation
  - Internal valuation

ASU 2021-10

- ASU 2021-10, *Government Assistance*
- Effective with fiscal years beginning after 12.15.21 (12.31.22 year-ends); early adoption permitted; prospective or retrospective adoption
- Accounting for Paycheck Protection Program loans, Economic Injury Disaster loans, and Employee Retention Credits
- Disclosures about government assistance
  - Nature of the transactions and the related accounting policy
  - Financial statement line items and the related amounts
  - Any significant terms or conditions, including any related commitments or contingencies

ASU 2020-04

- ASU 2020-04, *Reference Rate Reform (Topic 848) - Facilitation of the Effects of Reference Rate Reform on Financial Reporting*
- Effective 3.12.20 (issuance date of the ASU) through 12.31.22
- The London Interbank Offered Rate (LIBOR) is one of the most widely used reference rates; the LIBOR rate is being phased out (the overnight, 1-month, 3-month, 6-month, and 12-month LIBOR rates will continue to be published through 6.30.23)
- Provides optional relief to ease accounting transition due to the replacement of the LIBOR rate as a reference rate in receivables, debt, leases, derivatives, and/or other contracts
- ASU 2021-01, *Reference Rate Reform (Topic 848) - Scope*, subsequently expanded the scope of ASU 2020-04 to include certain other derivative instruments
- General theme is to allow for the carryover of current accounting treatment when changes to the contract are just due to the inclusion of a replacement reference rate
- Such a contract modification does not require contract re-measurement at the modification date or the reassessment of a previous accounting determination
- Debt - prospectively adjust the effective interest rate and account for the modification as if the modification was not substantial

ASU 2019-12

- ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*
- Private companies - effective with fiscal years beginning after 12.15.21 (12.31.22 year-ends); early adoption permitted; prospective, retrospective, or modified retrospective adoption depending on the specific element
- Simplifies the accounting for income taxes by removing certain exceptions (narrowly focused)
  - Recognition of a deferred tax liability for equity method investments when a foreign subsidiary becomes an equity method investment
  - Recognition of a deferred tax liability for a foreign subsidiary when a foreign equity method investment becomes a subsidiary
  - Incremental approach for an intra-period tax allocation when there is a loss from continuing operations or a gain from other items (i.e., discontinued operations or other comprehensive income)
  - Calculating income taxes in an interim period when the year-to-date loss exceeds the anticipated loss for the year
- Simplifies the accounting for income taxes by requiring (or not requiring)
  - Not requiring an entity to allocate the consolidated amount of current and deferred tax expense to a legal entity that is not subject to tax in its separately issued financial statements (the entity may however elect to do so)
  - Requiring the recognition of a franchise (or similar) tax partially based on income as an income-based tax
  - Requiring the evaluation of when a step-up in the tax basis of goodwill should be considered
  - Requiring the reflection of the effect of enacted changes in tax laws or rates in the annual effective tax rate computation in the interim period that includes the enactment date

ASU 2016-13

- ASU 2016-13, *Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*
- Private companies - effective with fiscal years beginning after 12.15.22 (12.31.23 year-ends); early adoption permitted
- Requires a financial asset (including trade accounts receivable) measured at amortized cost to be presented at the net amount expected to be collected
- The current (pre-ASU 2016-13) standards apply an incurred loss approach which delays recognition until it is probable a loss has been incurred vs. the expected loss model per ASU 2016-13
- The income statement will reflect the measurement of credit losses for newly-recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period
- Expected credit losses based on historical experience, current conditions, and reasonable and supportable forecasts
- Enhanced note disclosures required